GavekalResearch

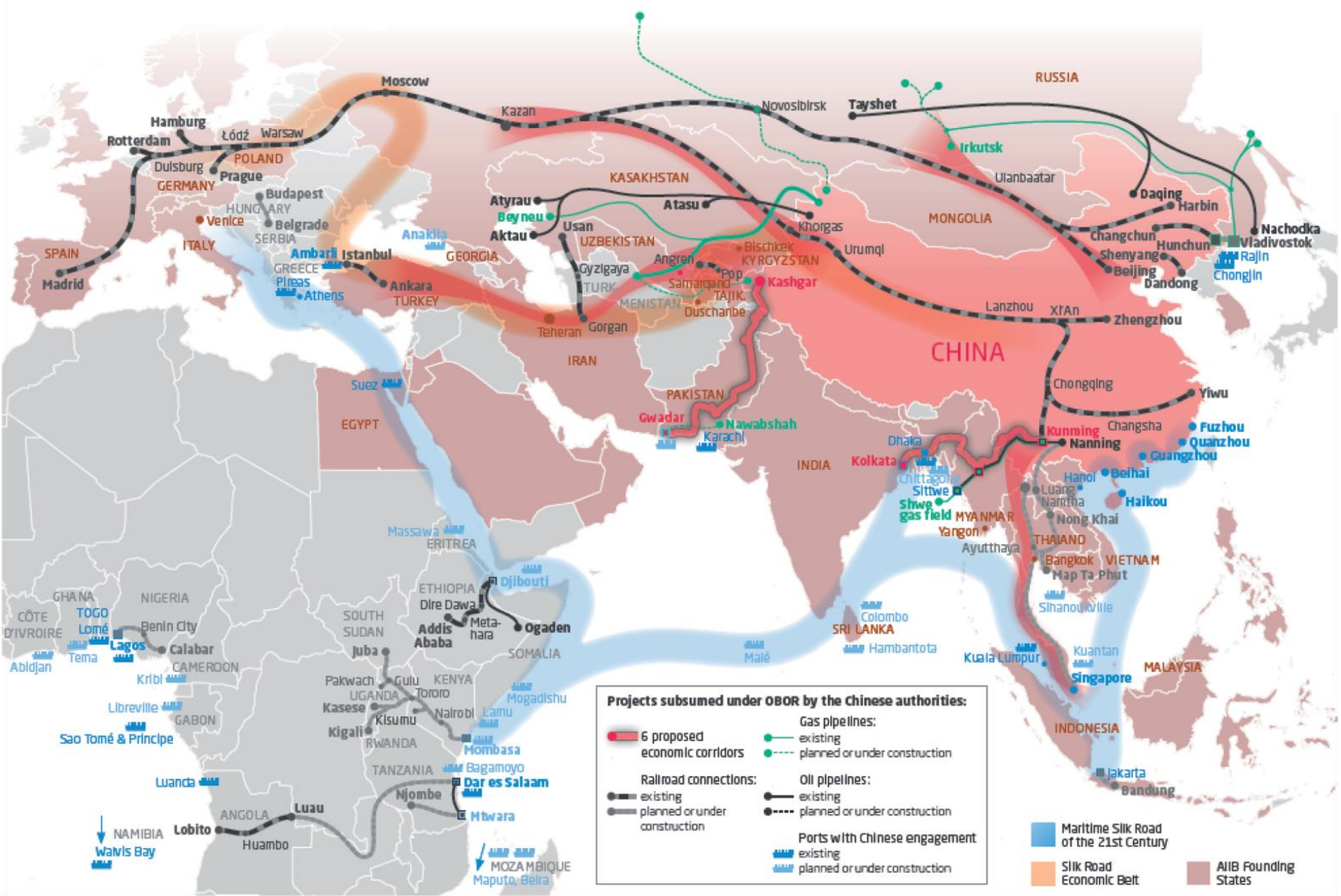
January 2020

The Surprises of 2019 & Consequences for 2020

By Louis-Vincent Gave

#1 Surprise of 2019: the HK vote

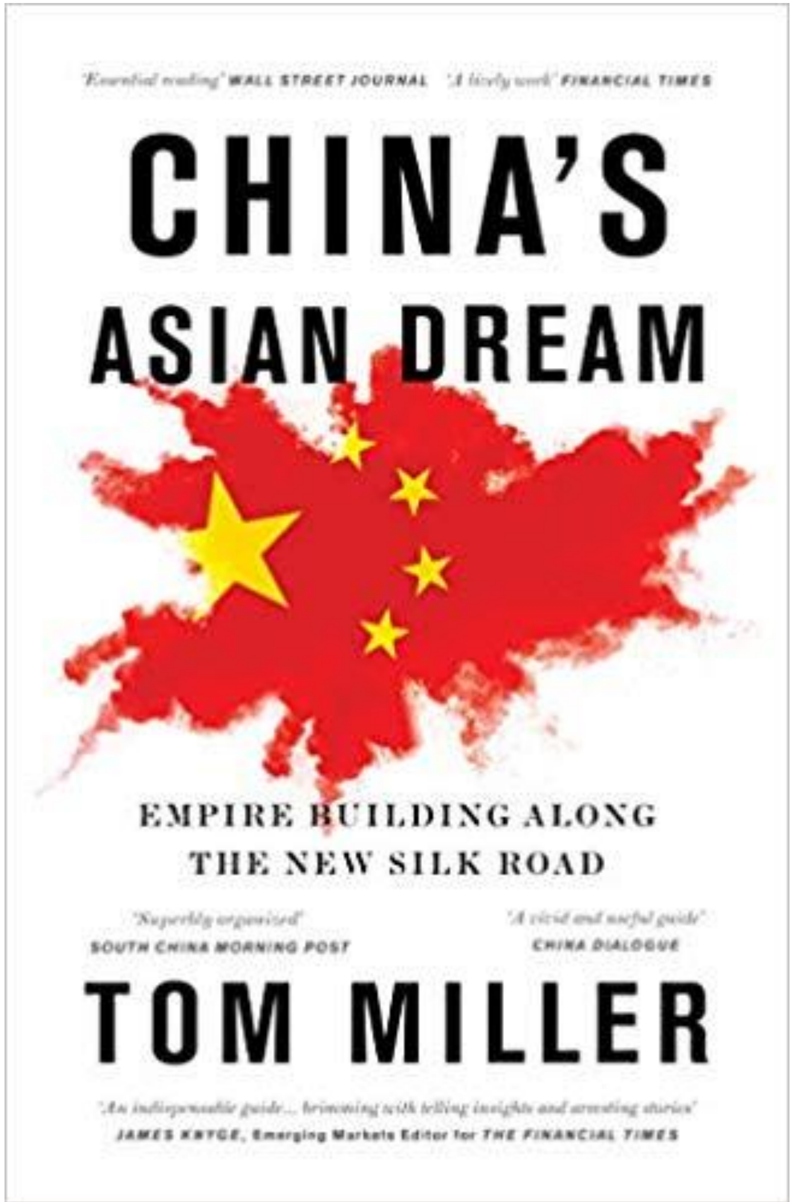
China, under Xi Jinping has imperial ambitions

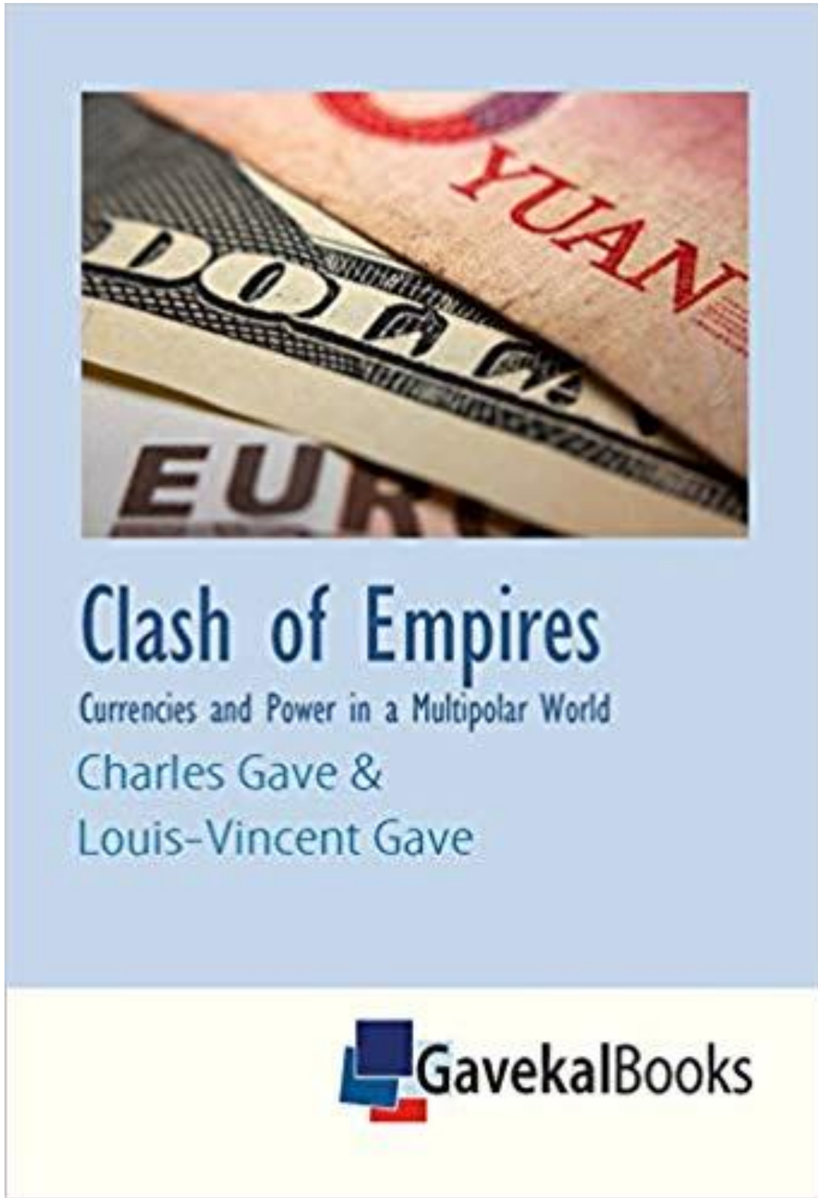


Source: Mercator Institute for China Studies

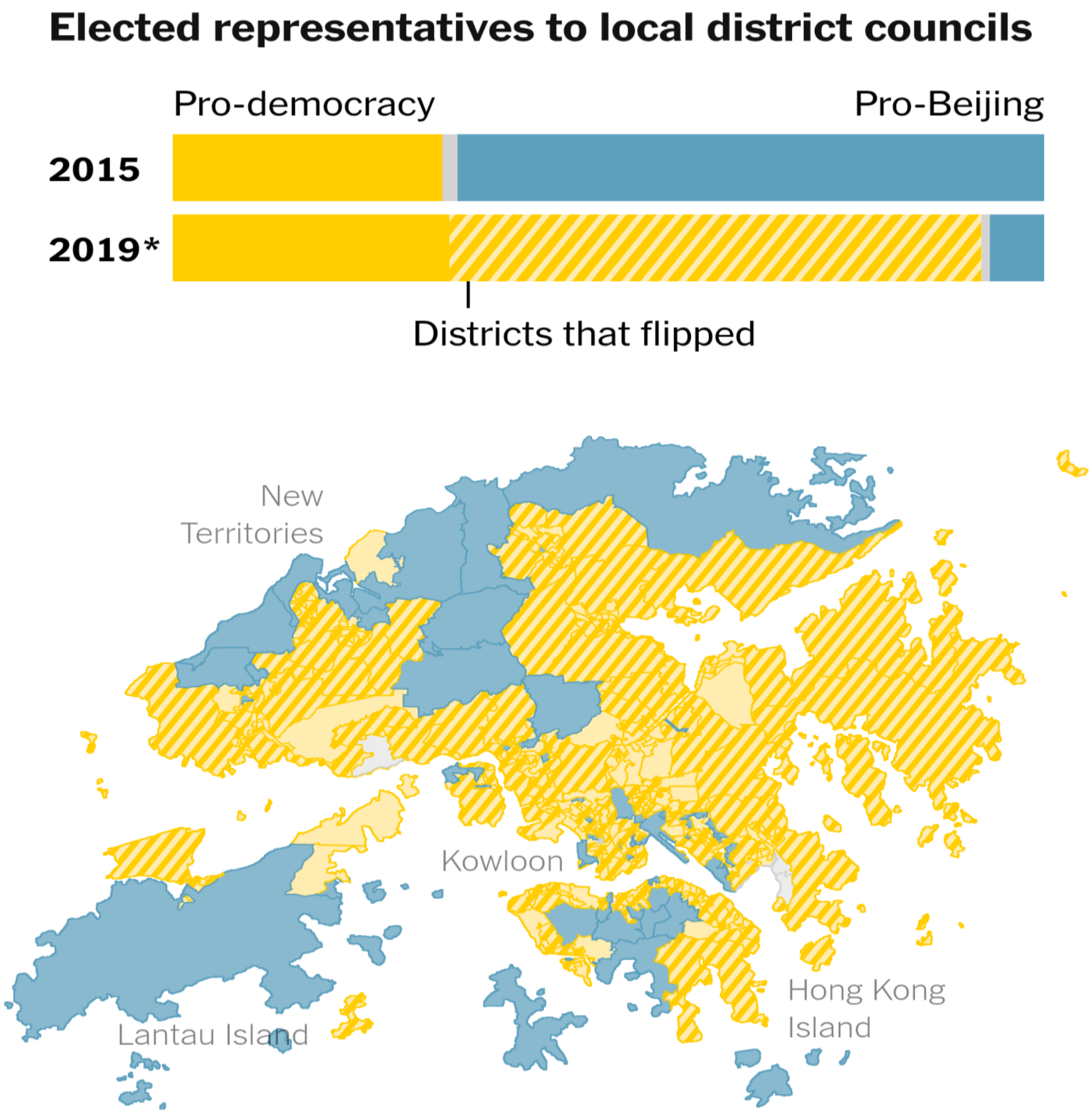
GavekalResearch

Two must-read books on China's imperial ambitions





But how does the HK vote fit into these imperial ambitions?



The HK vote creates an immediate problem for China

- **Start:** Can HK still be relied to be the capital market that will fund China's "Asian Dream"?

Cracking down on HK would be tantamount to 'destroying the village in order to save it'. So Chinese policy-makers are obviously hoping that the situation in HK resolves itself. At the same time, there must be an acknowledgement that hope is not a strategy. China thus needs a "plan B".

- **Plan B:** the back-up plan has to be the promotion of Shanghai and Shenzhen as parallel capital markets to rival HK.
- **The problem with Plan B:** Shanghai and Shenzhen can't be credible as financial centres unless China opens up capital controls much wider.
- **The problem with opening up capital controls:** The fear has to be that if capital controls loosen up, money will pour out of China, hereby destabilizing China's financial stability, triggering a RMB devaluation that would anger President Trump etc…
- **So if you are going to open up capital controls, you better talk up the currency at the same time…**

Cue Yi Gang's/Bob Rubin's speech

A very important shift in PBoC rhetoric followed the HK vote

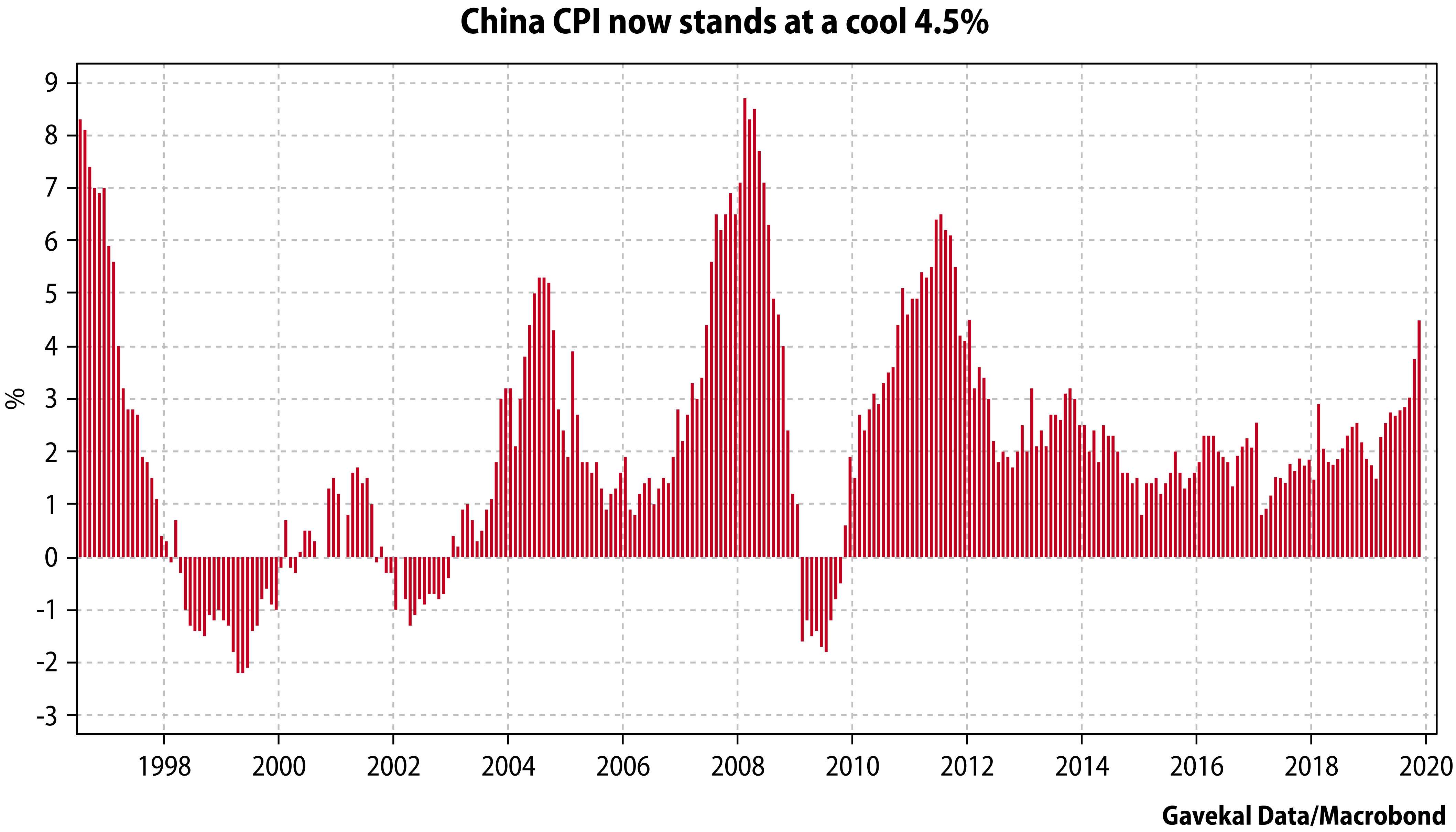
Yi Gang in June 2019

- "PBoC has tremendous room to adjust monetary policies should trade war deepen"
- "value of the RMB should be set by the market"
- "not wedded to defending a particular level for the RMB"

Yi Gang in December 2019

- "China should maintain a normal monetary policy and China will not resort to QE, even as the monetary policies of the world's economies are approaching ZIRP"
- "China should not let the money held by the Chinese to become worthless"
- "Maintaining positive interest rates… is in line with the Chinese people's saving culture, thus beneficial to the economy"

This shift can also be explained by the domestic inflation situation



And by the need to strike a trade deal with the US

February 2019

U.S. aims to combat Chinese currency manipulation in trade deal: Lighthizer

1 MIN READ

December 2019

By EMILY TILLETT / CBS NEWS / *December 15, 2019, 10:38 AM*

Lighthizer hails USMCA, China deals as "most momentous day in trade history"

Share / Tweet / Reddit / Flipboard / Email

A New "Plaza Accord"?

Whatever the driving reason, in 2020, we are likely heading to stronger RMB

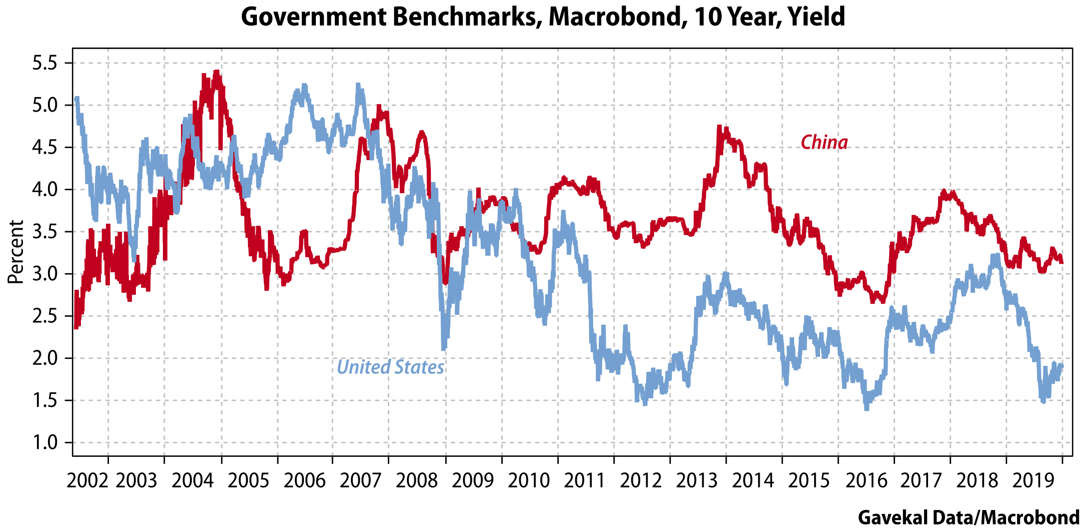
	Tighten capital controls and promote domestic growth through RMB devaluation	Open up capital controls and promote stronger RMB
How to do it	- Easier monetary policy - Easier fiscal policy	- Talk up RMB - Push US into easier monetary policy
Advantages	- Stronger growth helps China sweep debt problems under rug	- Deals with inflation problem - Solves trade tensions with US as DJT is fundamentally a mercantilist
Problems	- Creates future imbalances - May worsen trade war, which in turn would hurt growth	- May promote speculation and 'Plaza Accord syndrome' (i.e.: Japan in the late 1980s)
Investment Implications	- Buy US growth stocks - Buy US Treasuries	- Buy China fixed income & gold - Buy AUD & CAD assets - Buy Macao, HK…

The recent rebound in the RMB is not a 'dead cat bounce'

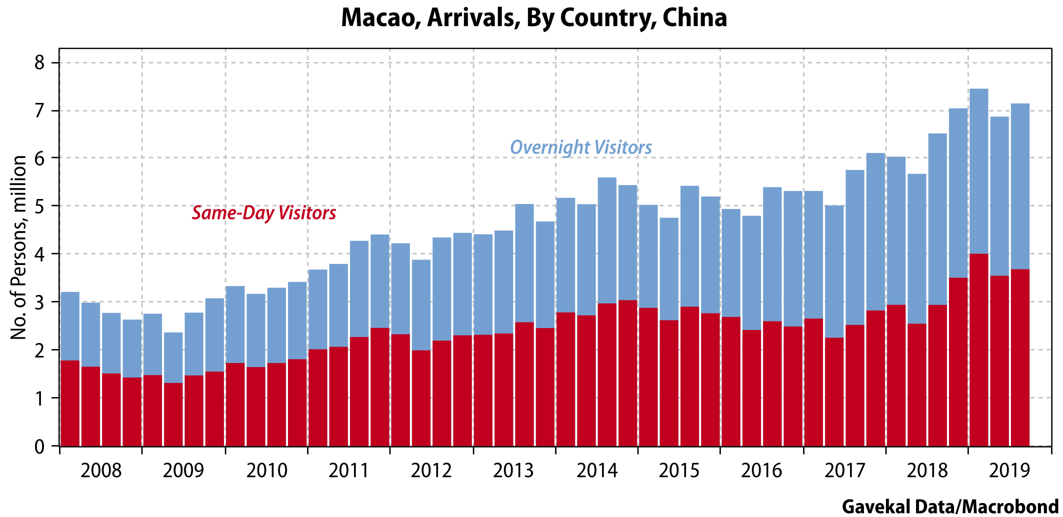
Gavekal Data/Macrobond

What are you doing about this policy shift in your portfolios?

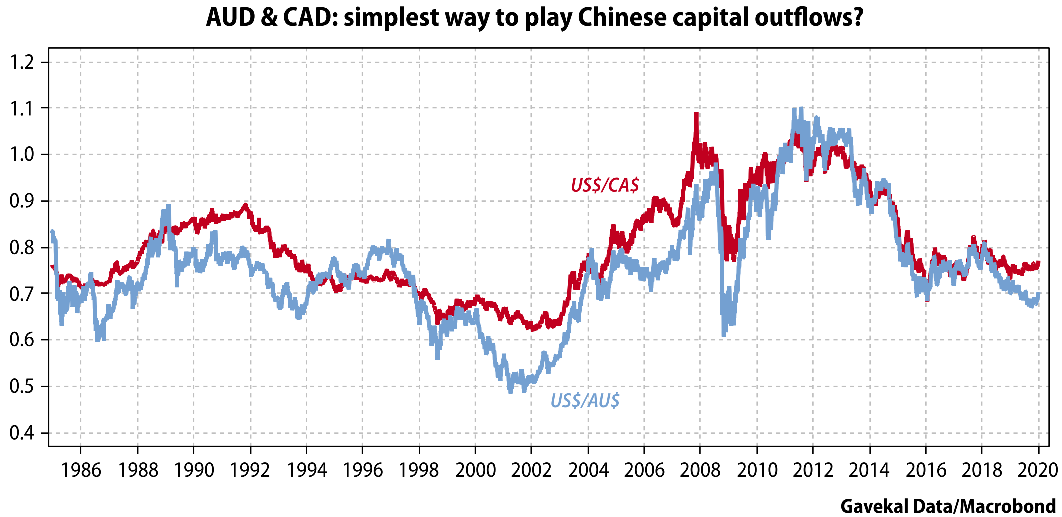
Buy Chinese bonds



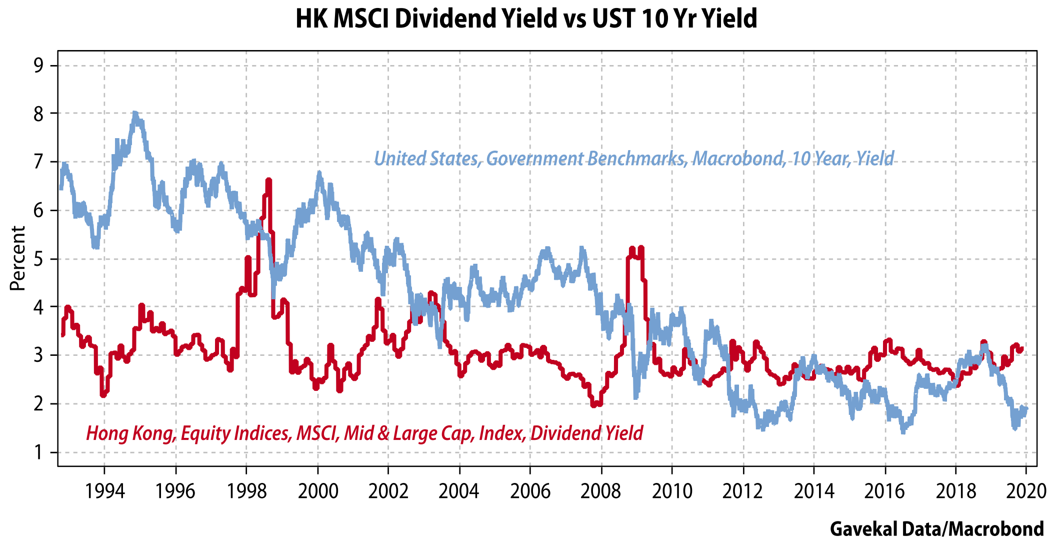
Buy Macao



Buy AU$ & CA$

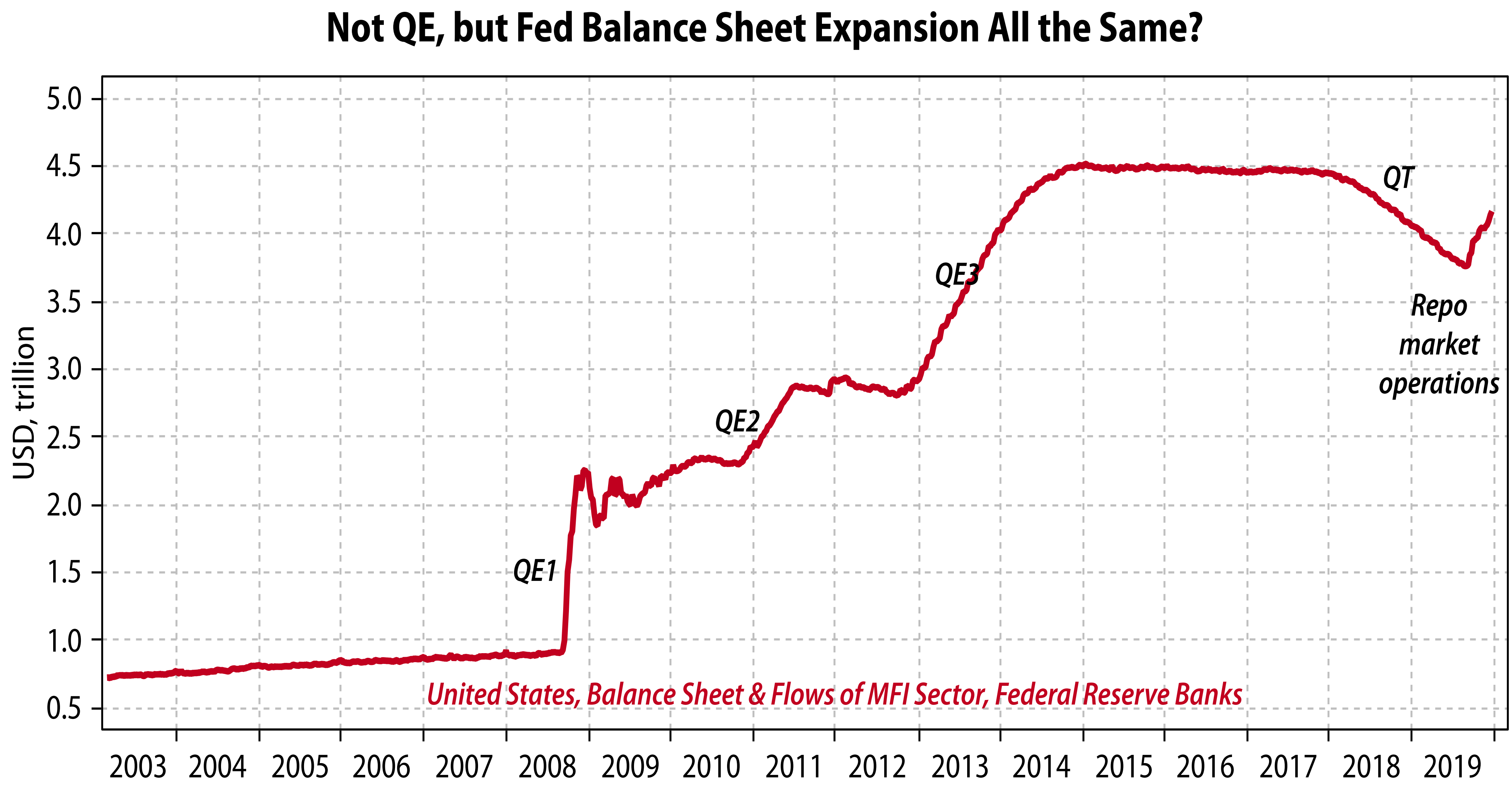


Buy HK?



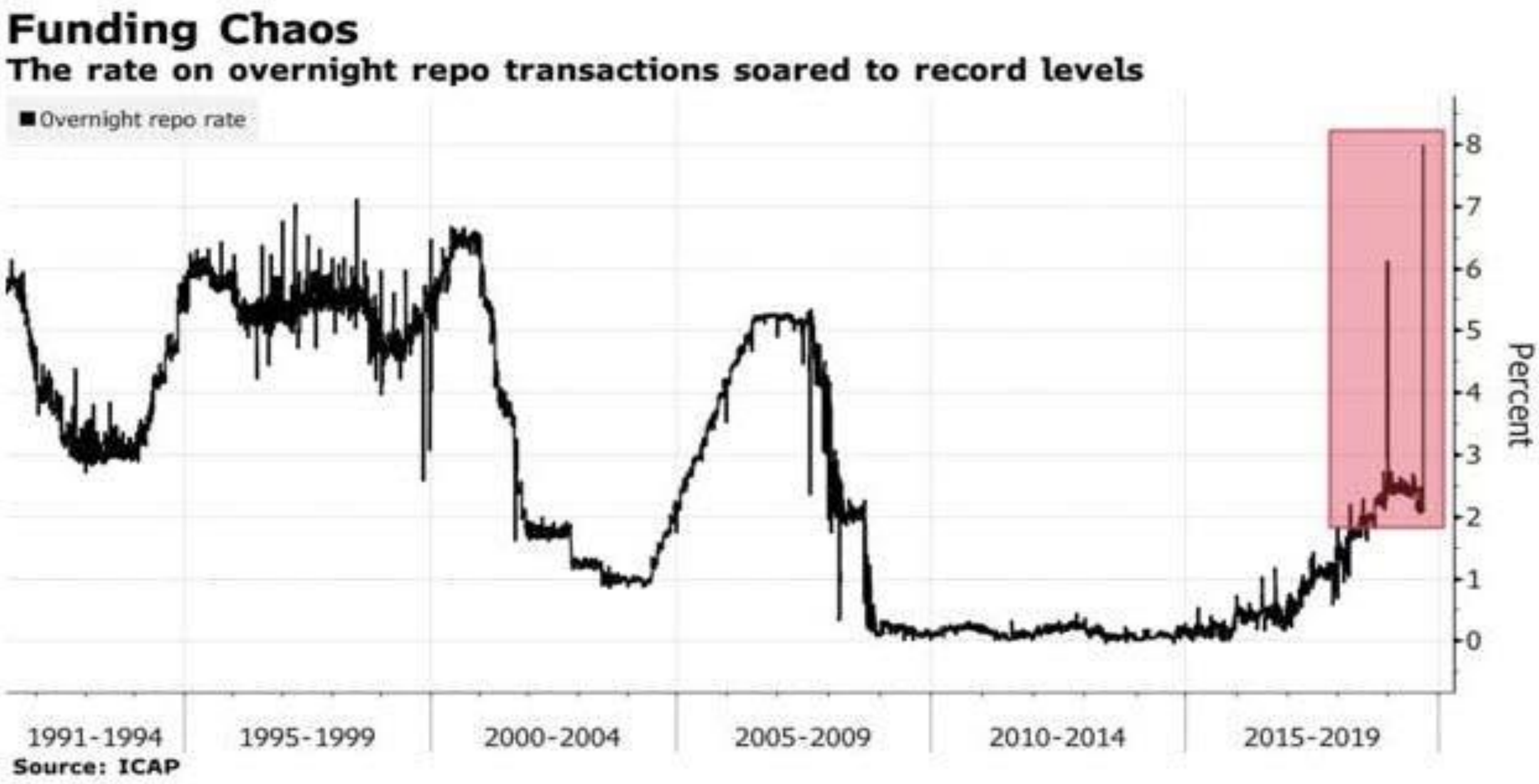
#2 Surprise of 2019: massive joint fiscal and monetary policy stimulus, and markets (mostly) brush it off

The Fed is back to QE

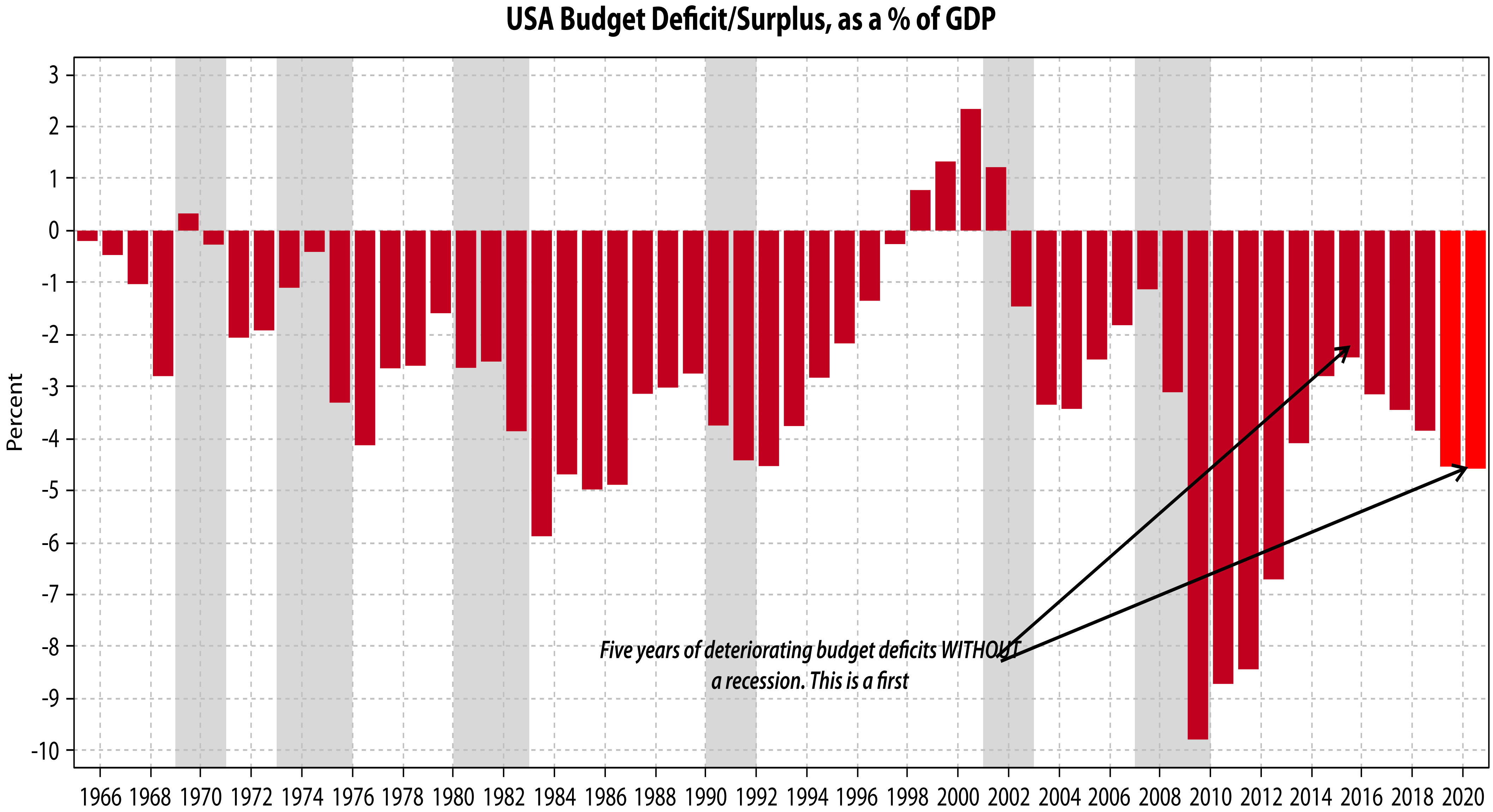


Gavekal Data/Macrobond

Behind the new QE, the dislocation in the repo market

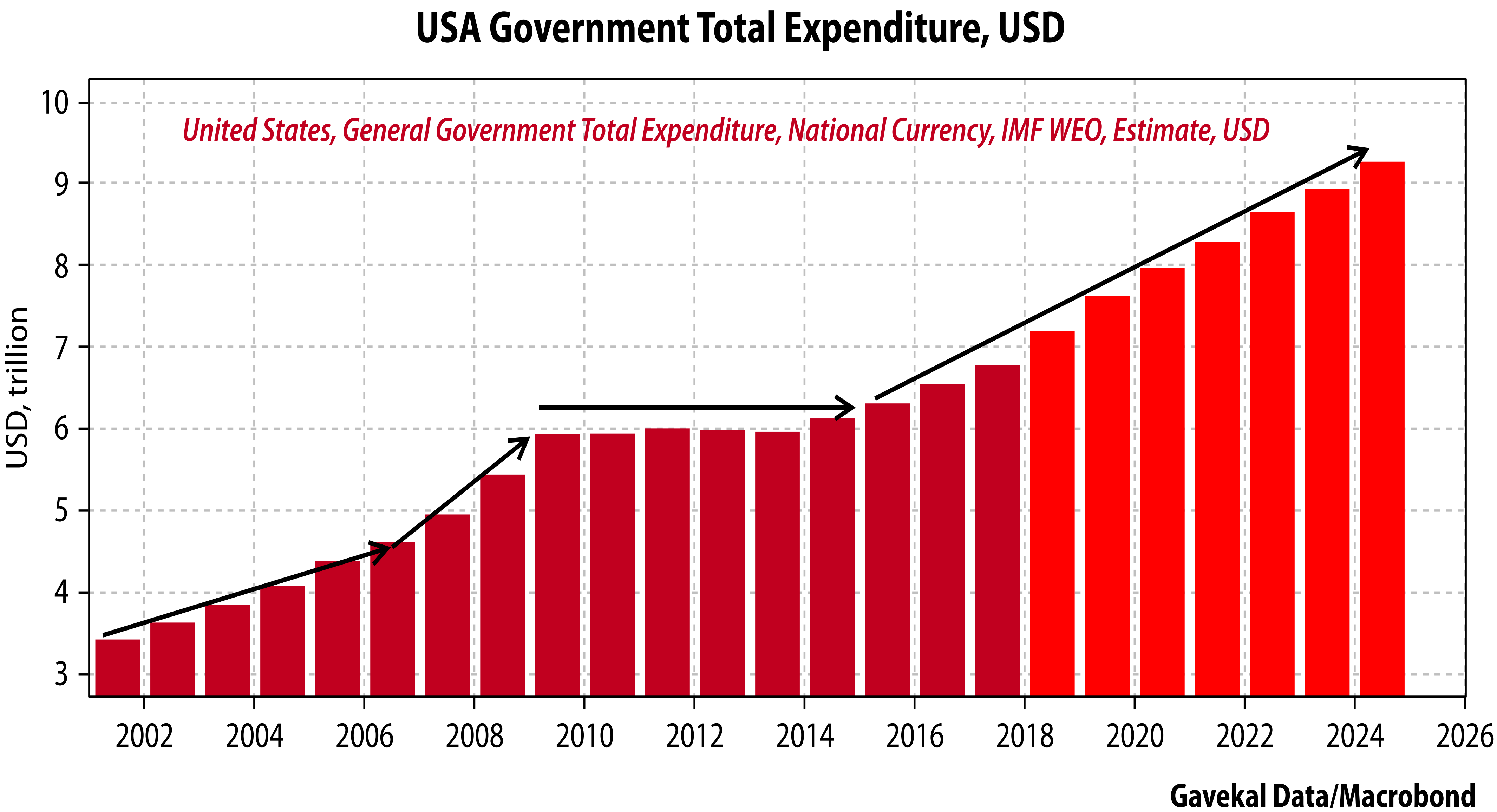


Behind the dislocation in the repo market are the run-away US budget deficits



Gavekal Data/Macrobond

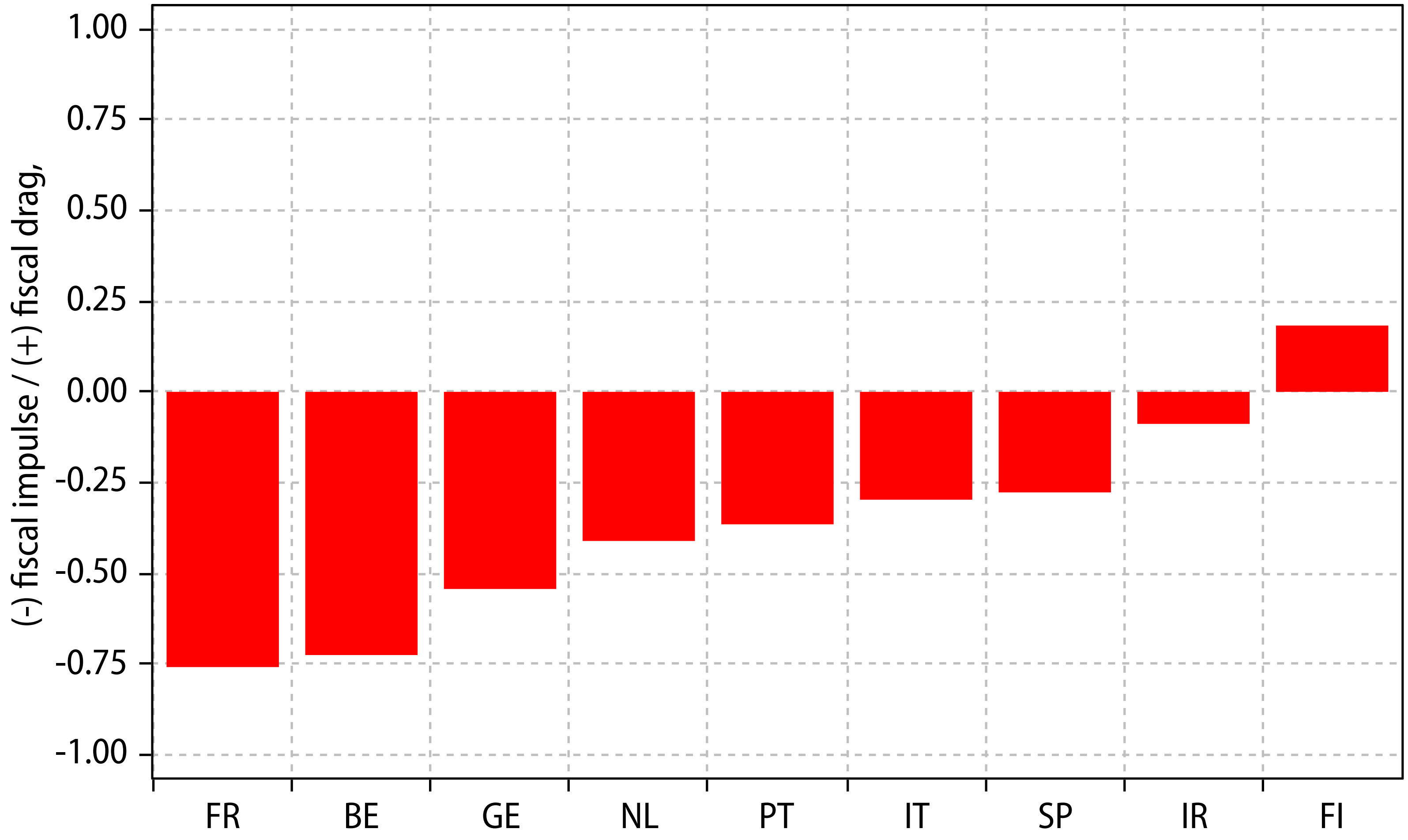
For the first time, Fed is now expanding at the same time as US Government



And it's not just the US: fiscal policy is also easing across Europe

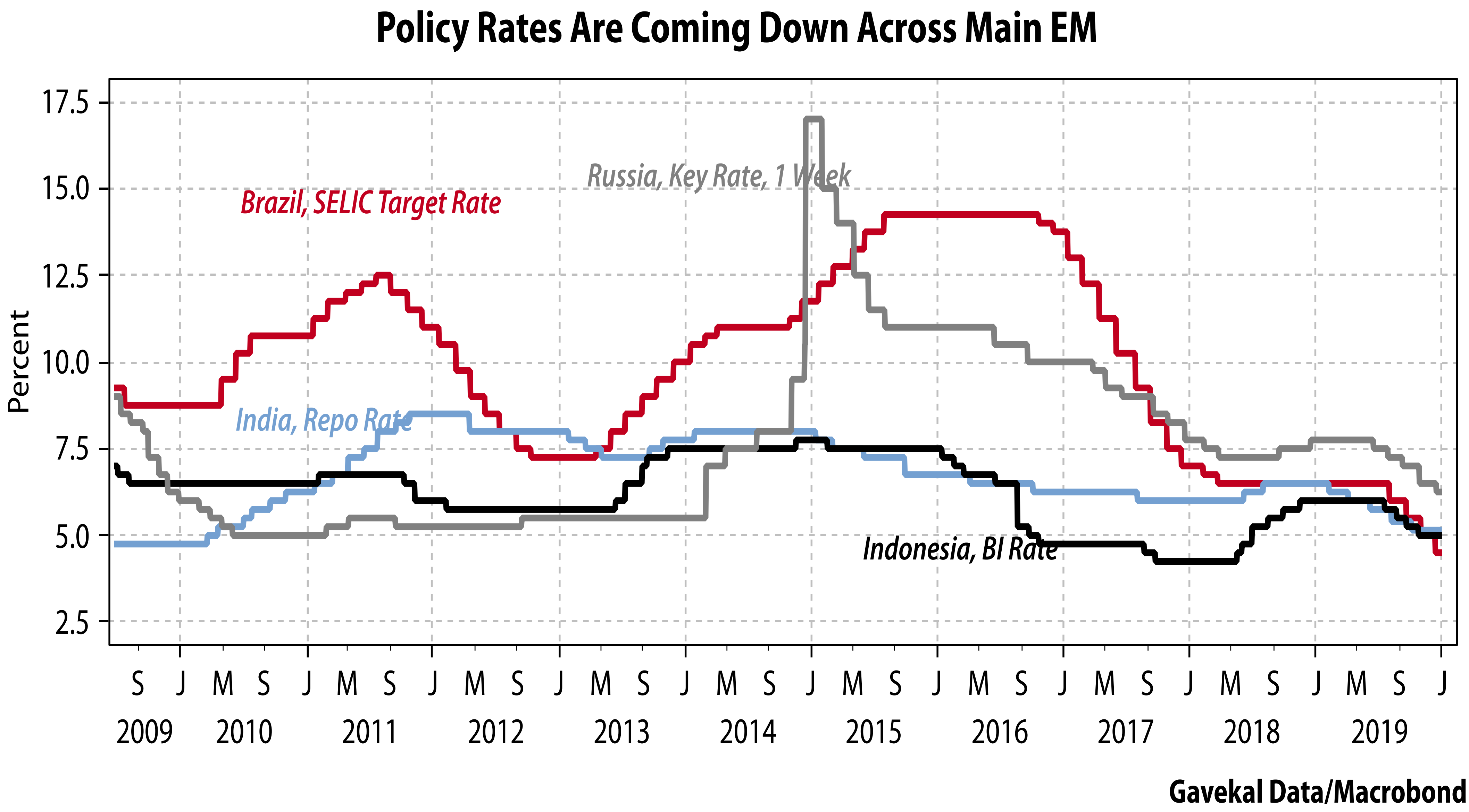
A modest, but broad based fiscal stimulus in the Eurozone in 2019

Change (pp of GDP) in cyclically ajdusted primary balance, average of OECD and IMF

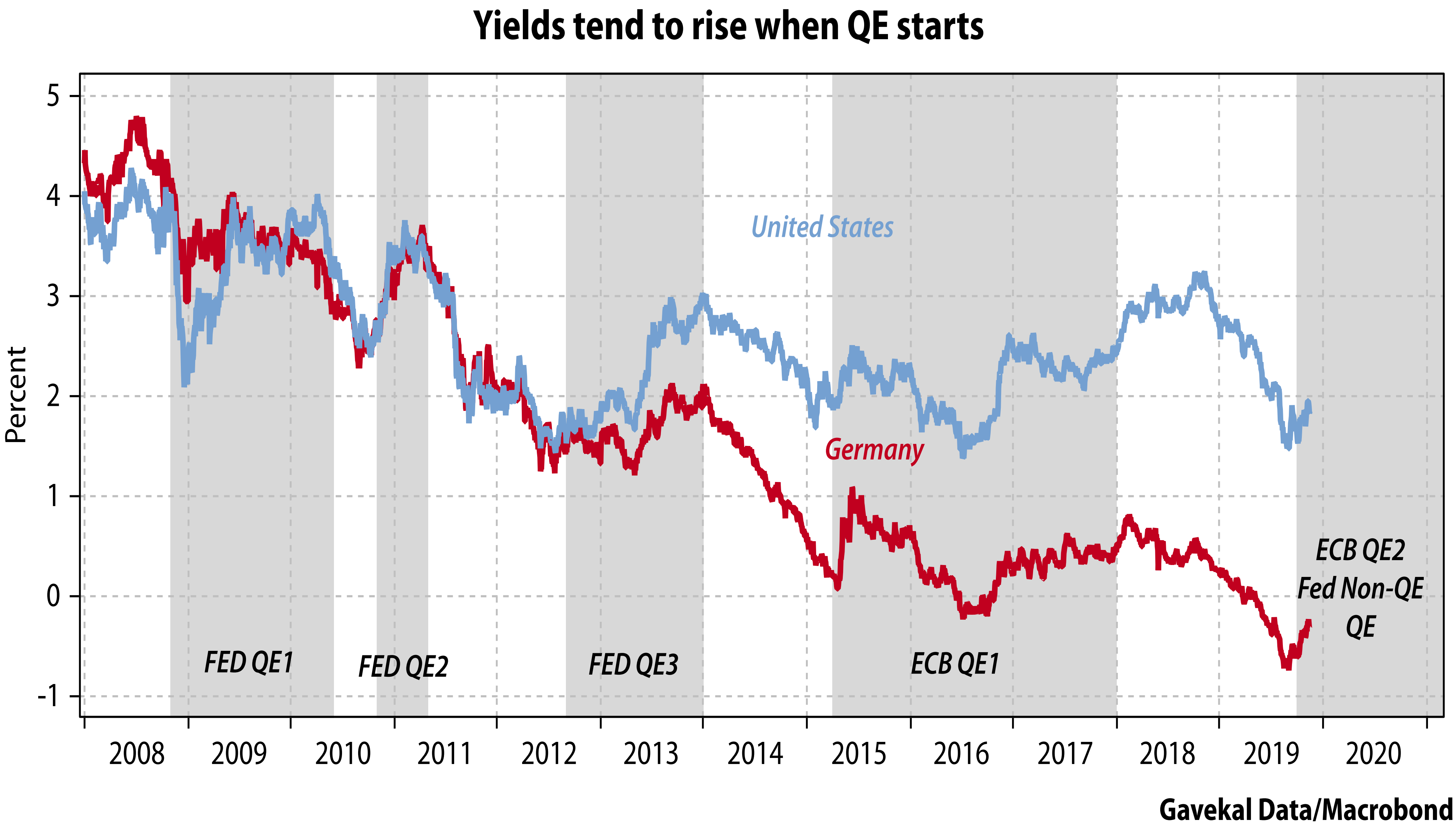


Gavekal Data/Macrobond

And same across EM: easier money, lower taxes and deregulation…

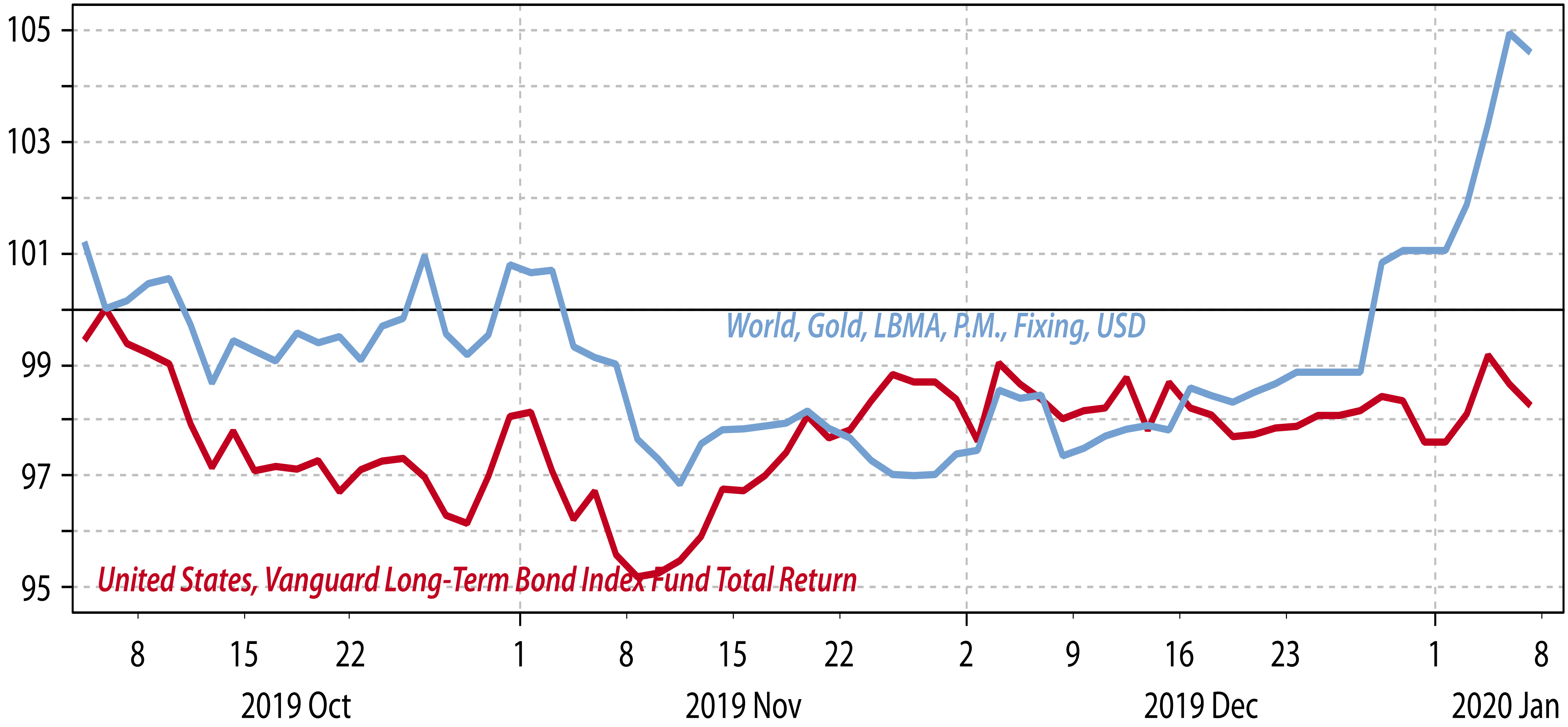


Easy money, easy fiscal… bullish bonds?



Bonds should be getting crushed… but they are still hanging in there

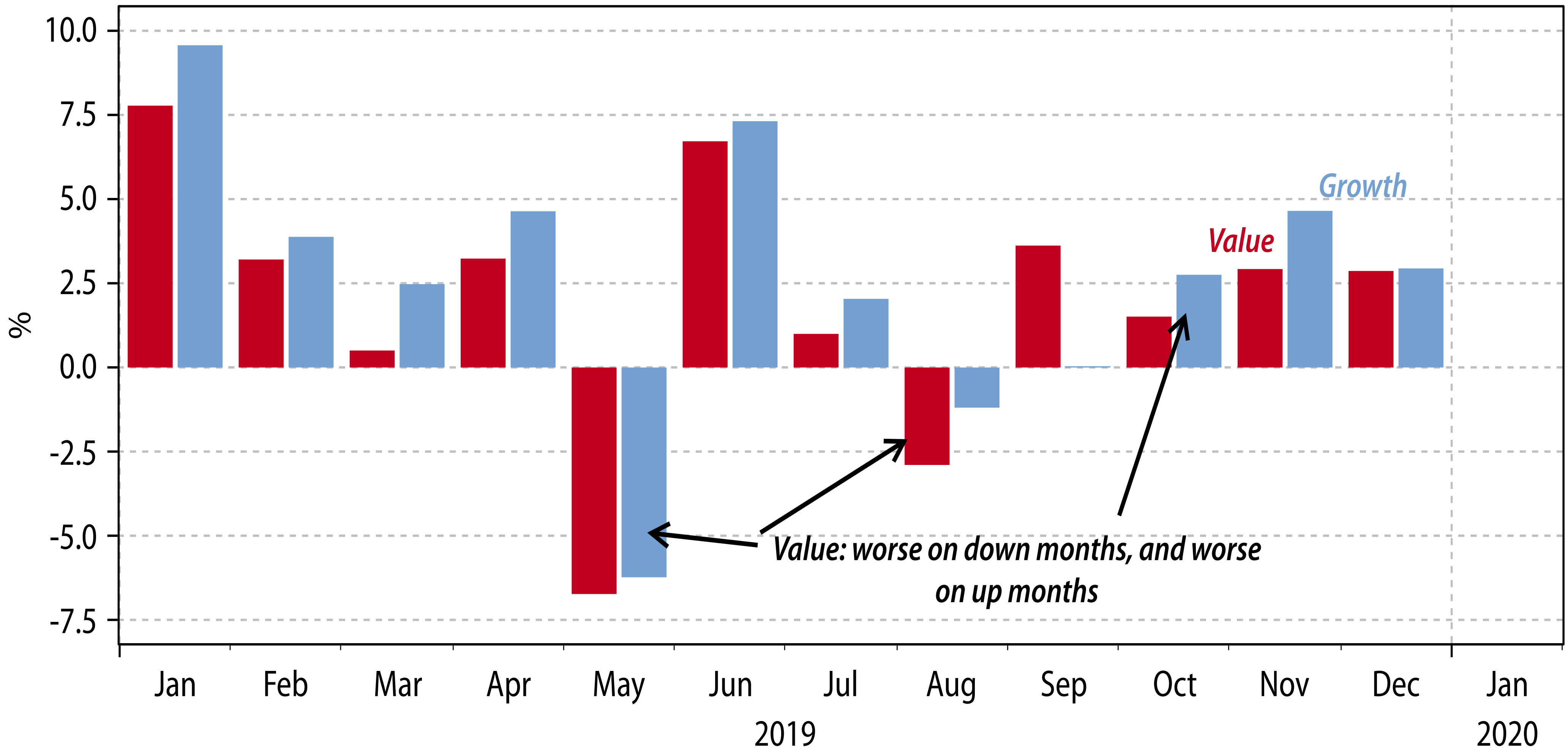
Gold & Total Return on US Long Bonds - The Summer Panic Buying of Anti Fragile Assets



Gavekal Data/Macrobond

With all this stimulus, value should be outperforming growth… but it is not

In 2019, September was the ONLY month when value outperformed growth

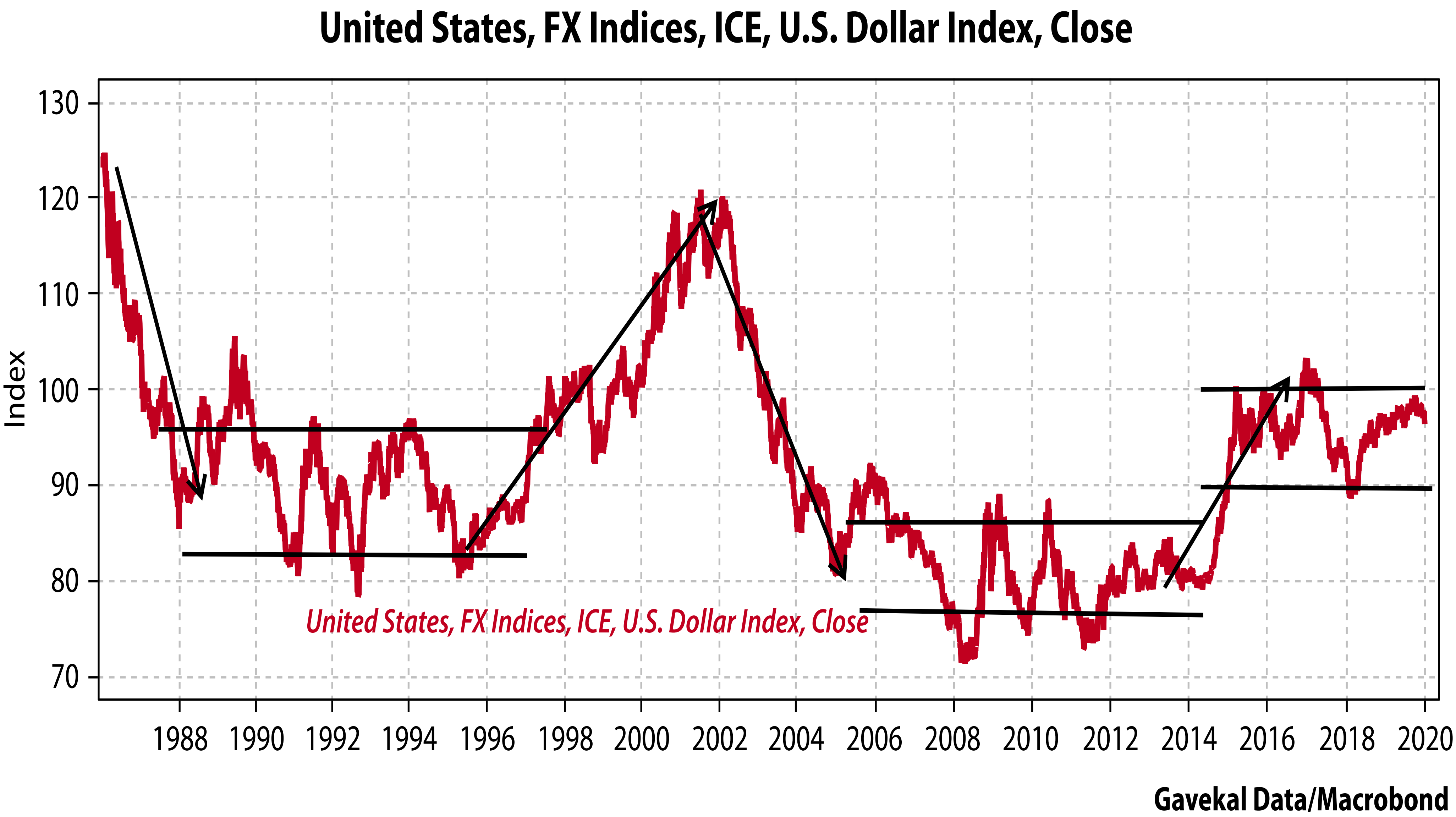


Gavekal Data/Macrobond

Question #2 for 2020: what will the Fed do?

	Continue to inject liquidity through 'non QE QE' & remain overly accomodative	Return to balance sheet normalization around March 2020
Immediate Risk	- US$ weakens and domestic inflation accelerates	- Markets tank just before an election and DJT starts to move to revoke Fed independence
Longer term risk	- Foreign investors start to question whether US$ is trustworthy reserve currency	- Funding crisis for US government and foreign investors start to question worthiness of US assets
Market impact	- Risk assets continue to move higher, with rotation from growth to value. Gold does well	- US Treasuries rally hard and only place to be remains US stocks. EM assets fare poorly
Assets to avoid	- US Treasuries - US$ - Overvalued growth stocks	- Emerging markets - Commodities - Gold

Maybe as long as US$ stays strong, rotation can not happen?



Is the environment for the US$ starting to (finally) turn?

GRAB

1) Pricing Hours | 2) Settings | World Currency Rates

Currency Basket: Major Currencies | Base: USD | Quote: Market

Pricing: Contributed | Calculate via USD | View: Historical % | OHLC

Zoom 100%

Name	Price	Net Chg	Time	1D%	5D%	1M%	3M%	6M%	YTD%
10) South African Ran...	14.0182	+.0420	5:32	-.299	+4.231	+4.048	+9.244	+1.104	-.299
11) New Zealand Dolla...	.6729	-.0015	5:32	-.222	+.059	+3.539	+7.750	+.885	-.222
12) British Pound (CM...	1.3247	-.0016	5:32	-.121	+4.496	+2.420	+7.542	+4.844	-.121
13) Swedish Krona (C...	9.3667	+.0166	5:31	-.177	-3.319	+1.908	+5.422	-.187	-.177
14) Australian Dollar (...	.7016	-.0008	5:32	-.114	-.327	+2.934	+4.654	+.834	-.114
15) Mexican Peso (CM...	18.9292	+.0498	5:32	-.263	+5.279	+3.407	+4.553	+.998	-.263
16) South Korean Won...	1156.02	+1.05	5:29	-.091	-2.674	+2.612	+4.046	+.727	-.091
17) Norwegian Krone ...	8.7736	-.0070	5:32	+.079	-.272	+4.449	+3.955	-2.171	+.079
18) Taiwan Dollar (CM...	29.986	+.075	5:29	-.250	+2.741	+1.737	+3.662	+3.545	-.250
19) Brazil Real (CMPL)	4.0198	+.0006	4:39	-.015	-2.873	+5.050	+3.552	-4.684	-.015
20) Singapore Dollar (...	1.3454	+.0007	5:32	-.059	+2.081	+1.561	+2.928	+.840	-.059
21) Swiss Franc (CMPL)	.9676	+.0011	5:32	-.124	+1.943	+2.532	+2.697	+2.036	-.124
22) Euro (CMPL)	1.1215	-.0014	5:32	-.125	-1.666	+1.264	+2.532	-.699	-.125
23) Danish Krone (CM...	6.6627	+.0083	5:31	-.125	-1.649	+1.253	+2.436	-.818	-.125
24) Canadian Dollar (...	1.2984	+.0006	5:32	-.046	+4.760	+2.426	+1.810	+1.194	-.046
25) Japanese Yen (CM...	108.65	+.06	5:32	-.064	+1.353	+.359	-.884	-.156	-.064

%Chg Calculated As Appreciation Vs Base Currency (XDF)

Almost all recent developments have been US$ bearish

- **Change in Fed policy** => US$ bearish
- **Brexit deal** => US$ bearish
- **Trade deal** => US$ bearish
- **US politics** => US$ bearish

Depending on how the presidential campaign goes, 2020 could well be the year when the US stops being the world's 'cleanest dirty shirt'. Instead, the US becomes the equivalent of bell-bottom pants, Abba albums, and monoskis. Something everyone had to have, and then five years later, were embarrassed about.

#3 Surprise of 2019: a third of global outstanding debt moves into negative yield

This is the biggest bubble in History

This current bubble, like all of its predecessors, rests on two pillars

It's different this time / It's a new paradigm

Some other sucker will buy this worthless paper from me at a higher price later on

The difference this time is the DDD: 1) Demographics, 2) Debt & 3) Deflation!

The sucker this time are the central banks, who will continue to buy any bond thrown their way

Key bubble belief: bonds are 'unique'; the more bonds we issue, the higher their price should be. Law of supply and demand does not apply!

Belief in non-existent inflation has led to dumb-bell portfolio outperformance

Growth stocks:
Because the global growth environment is weak, and because there is no inflation, let's buy overvalued growth stocks

Government bonds:
Still, the risk remains that we have a growth shock (China implodes? Euro growth tanks, Brexit…). So let's hedge our overvalued growth stocks with overvalued bonds!

However, given current valuations, both sides of the dumbbell portfolio are a bet on interest rates heading lower – *and this at a time when interest rates are already in deep negative territory across most of the developed world!*

In a world with no growth, you pay up for growth where you can find it

Top ten market caps: how often do winners stay on top?

1980	1990	2000	2010	2019 - June
IBM	NTT	Microsoft	Exxon Mobil	***Microsoft (1035bn)***
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	***Amazon (936bn)***
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	***Apple (913bn)***
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	***Google (766bn)***
Schlumberger	Toyota Motors	Wal-Mart	Microsoft	***Facebook (538bn)***
Shell	Fuji Bank	Intel	ICBC	***AliBaba Group (421 bn)***
Mobil	Dai ilchi Kangyo Bank	NTT	Petrobras	***Tencent Hlgs (421bn)***
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Johnson & Johnson (371bn)
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	JP Morgan Chase (360bn)
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Exxon Mobil (320bn)

Prominent beliefs : Peak oil, US businesses are just better run

Underweight USA
Underweight Energy

Prominent beliefs : Japan will take over the world

Underweight Japan
Underweight Banks

Prominent beliefs : It's different this time; US is big TMT boom winner

Underweight USA
Underweight TMT

Prominent beliefs : Peak oil, China taking over the world

Underweight China
Commodities

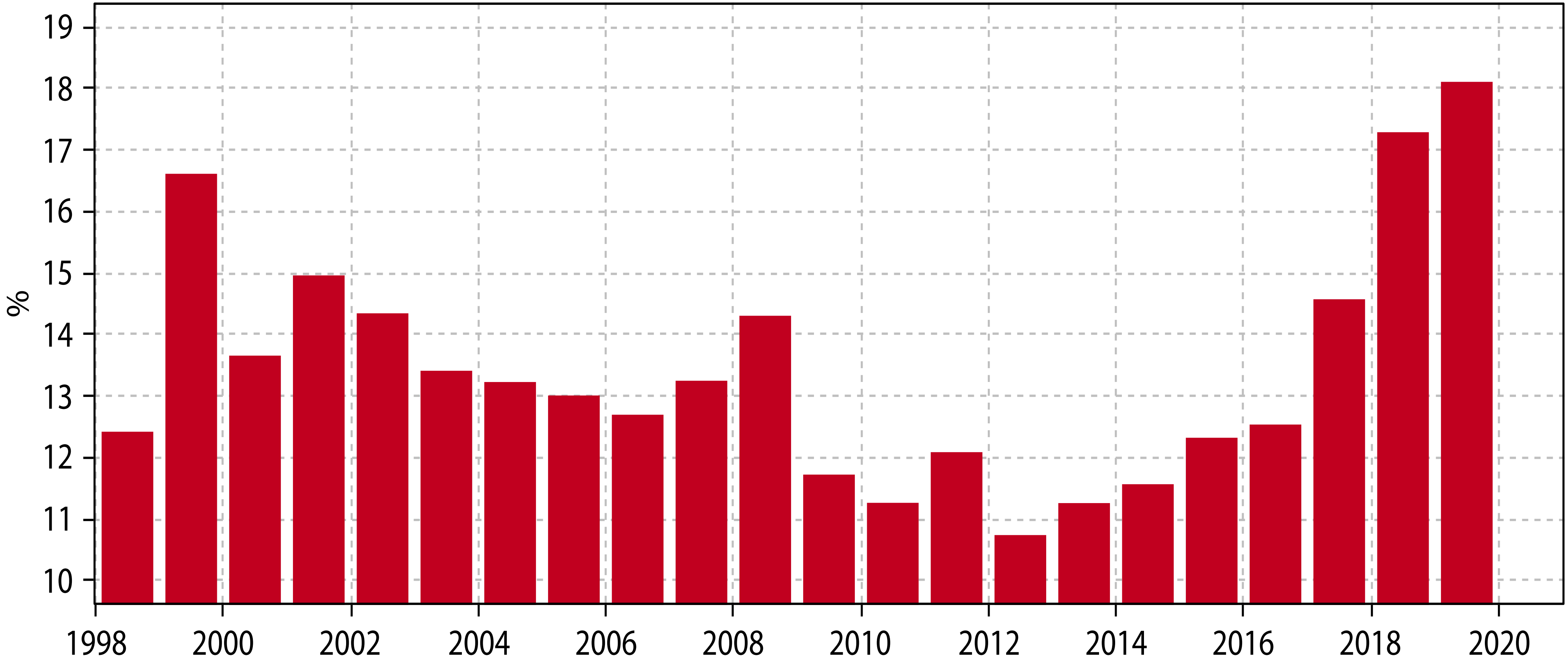
US is cleanest dirty shirt & tech will deliver growth thanks to monopoly

Fifth time is the charm?

Is the current set-up healthy?

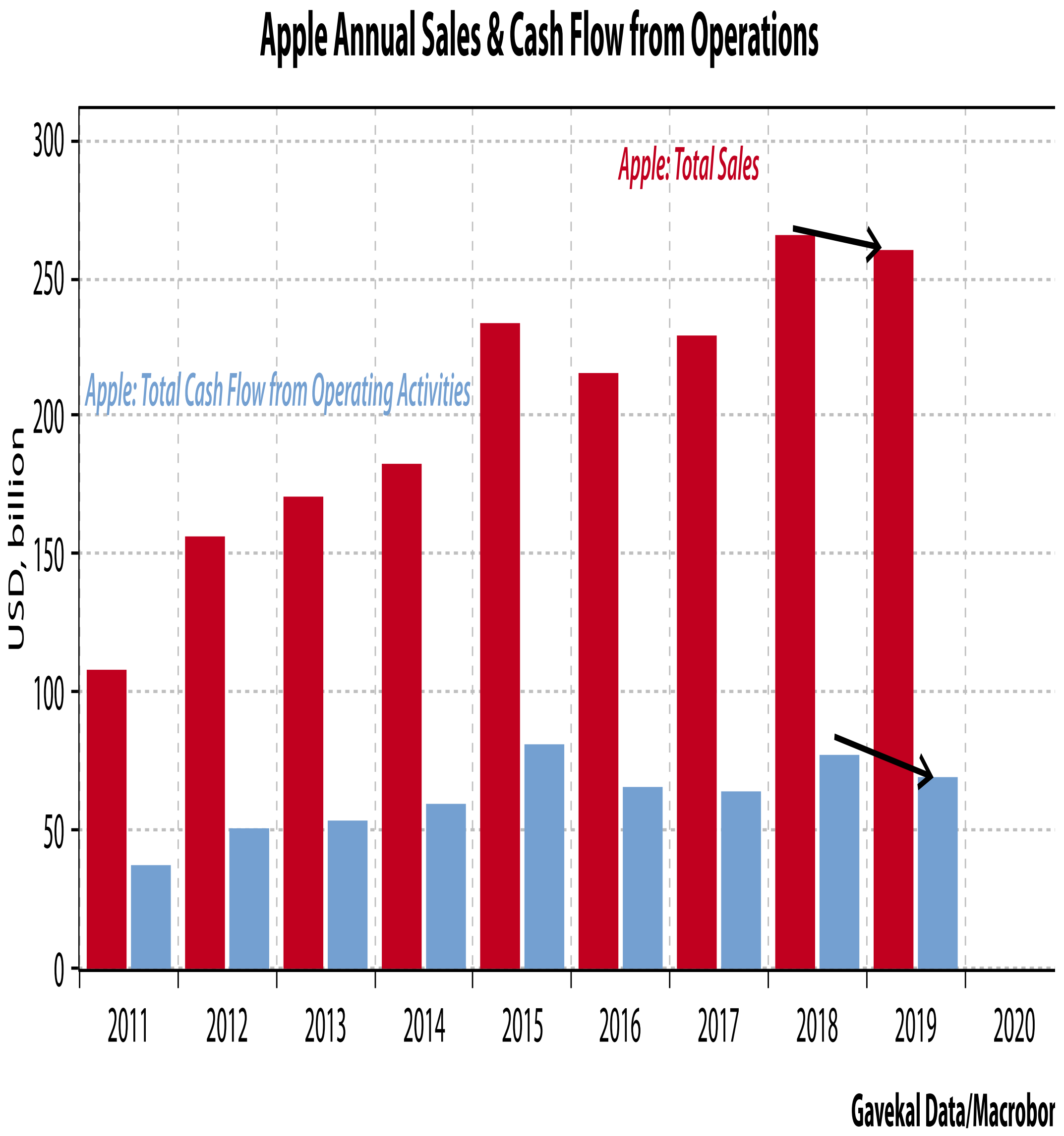
The size of the top five firms in the S&P 500 top is historically high

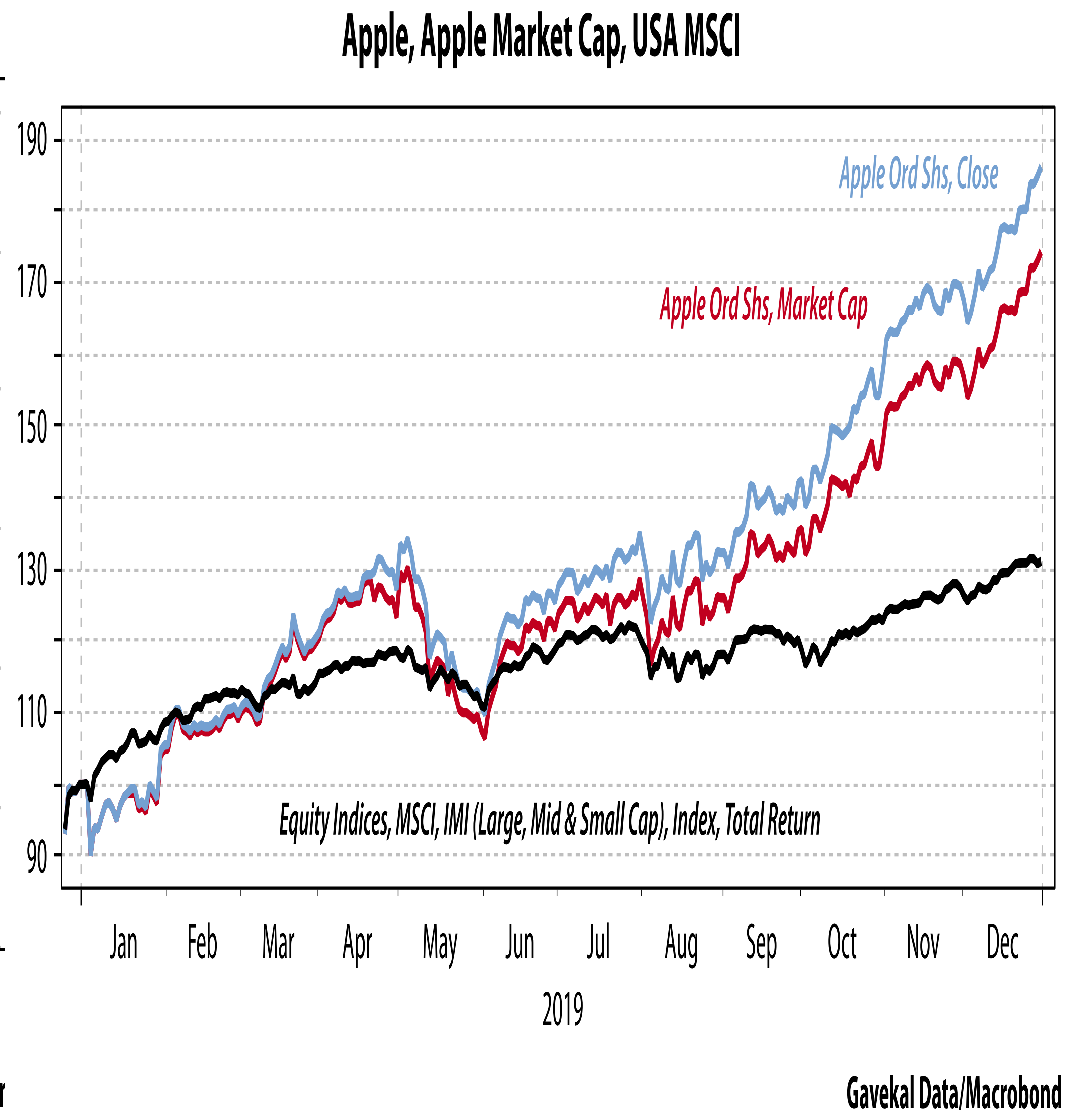
Total market cap of S&P500 top-five names as a share of S&P500 market cap



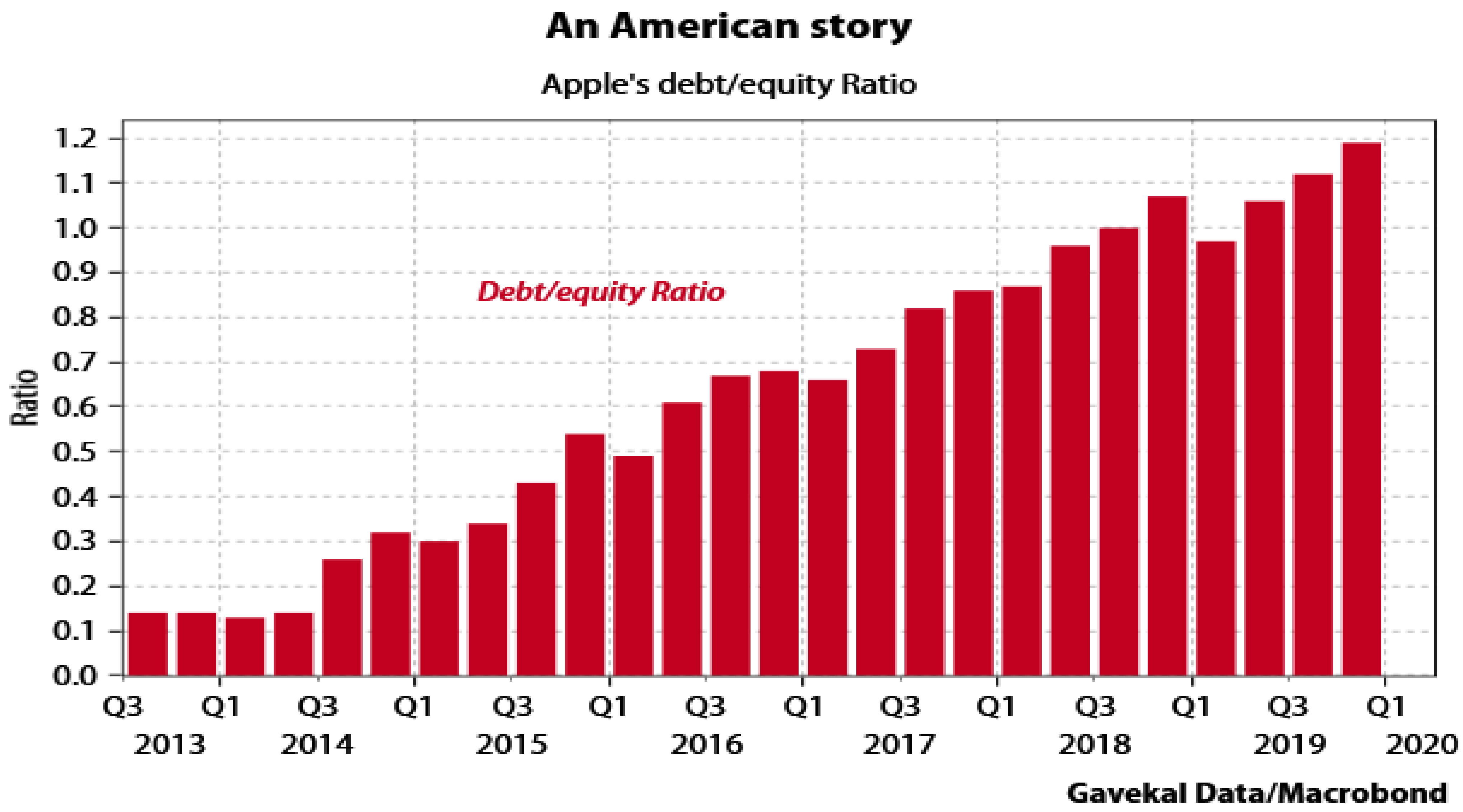
Bloomberg, Gavekal Data/Macrobond

Apple in 2019: falling sales, falling cash flows, share price +85%





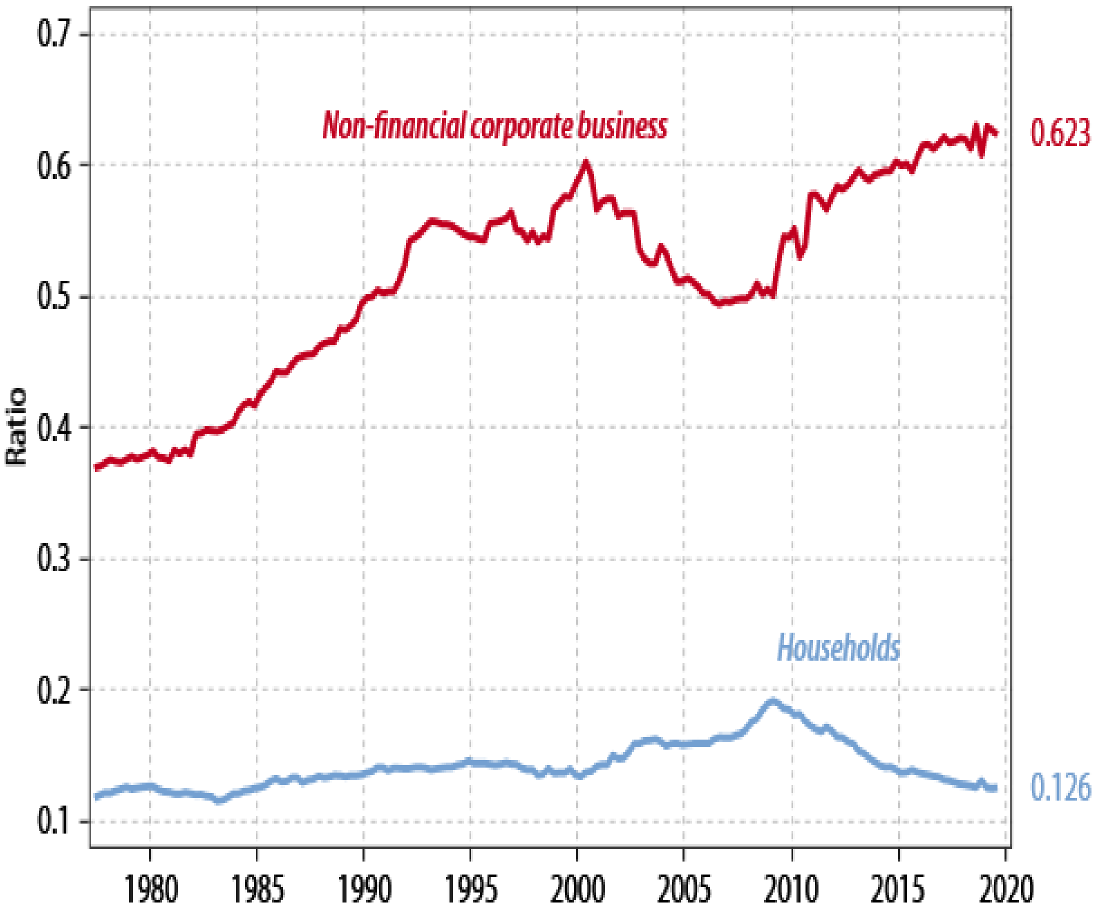
Part of this has been buy-back driven



The one concern for the US economy is the expansion of corporate debt

US households and companies diverge in their debt habits

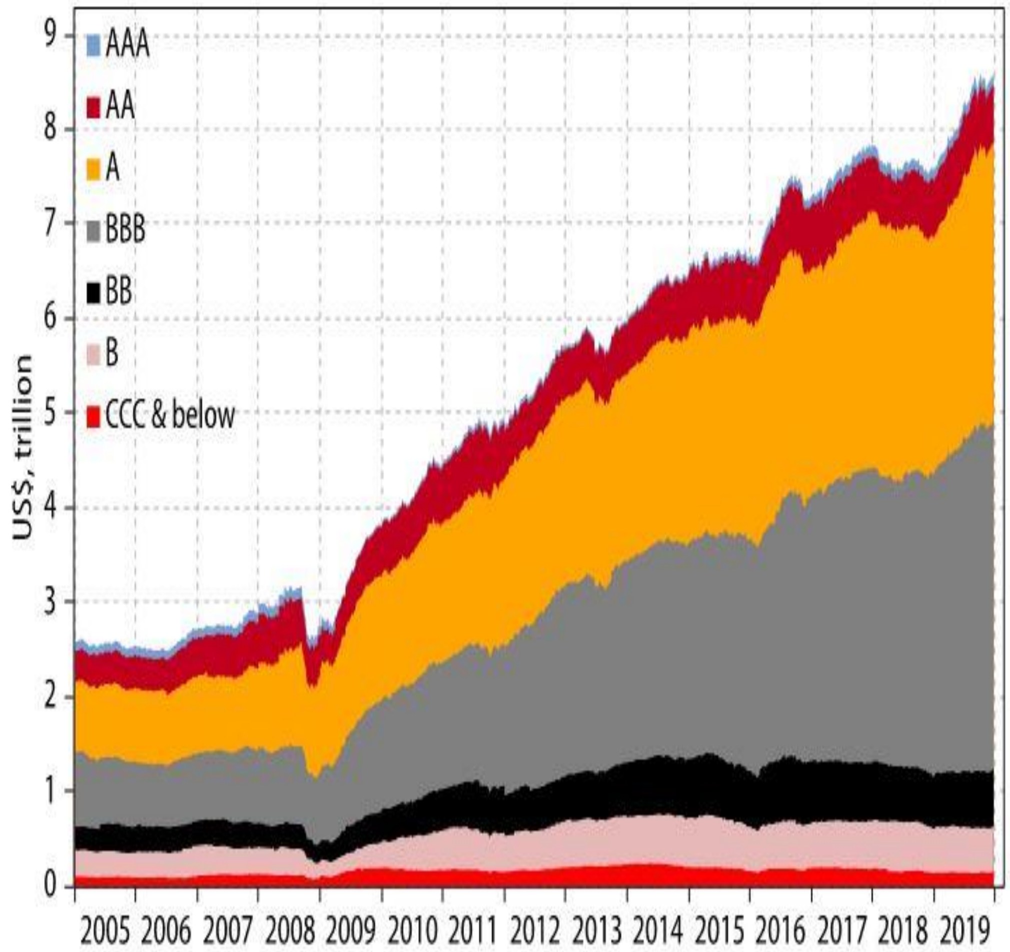
Leverage (liabilities/assets) in the US; households and corporations



Gavekal Data/Macrobond

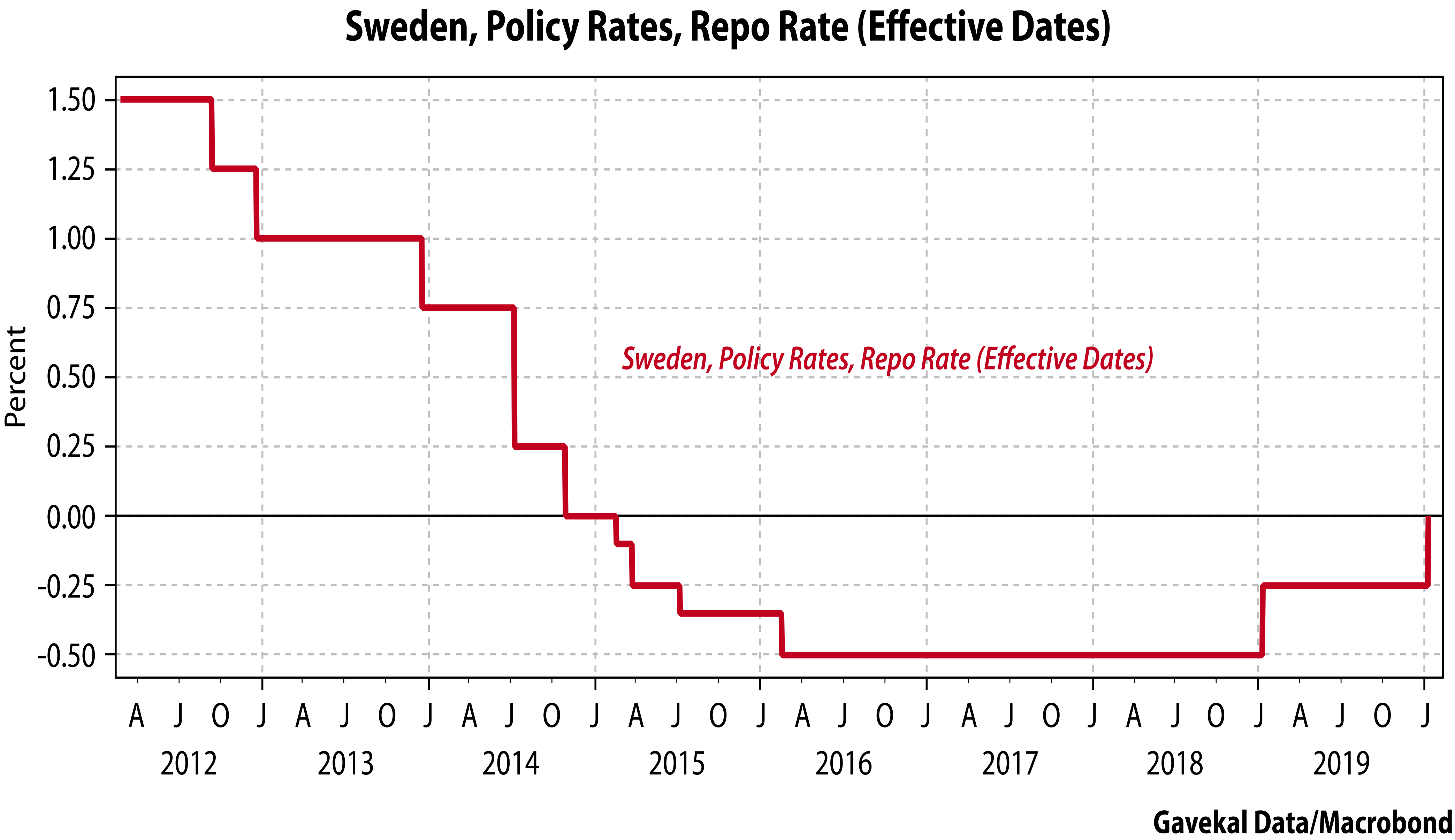
The size of corporate debt one rung above junk has never been greater

Market capitalization of US corporate bonds by credit rating



Gavekal Data/Macrobond

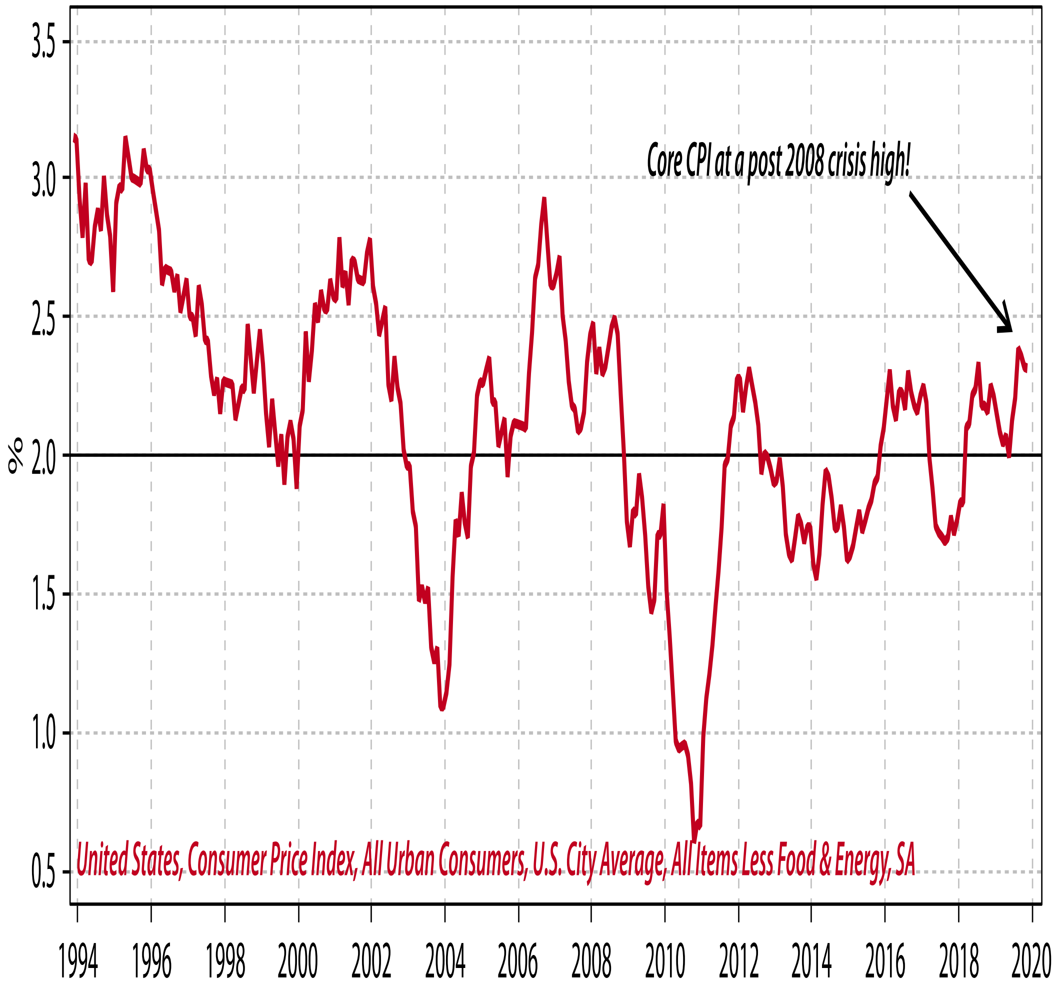
But could environment be changing: Riksbank abandons NIRP



GavekalResearch

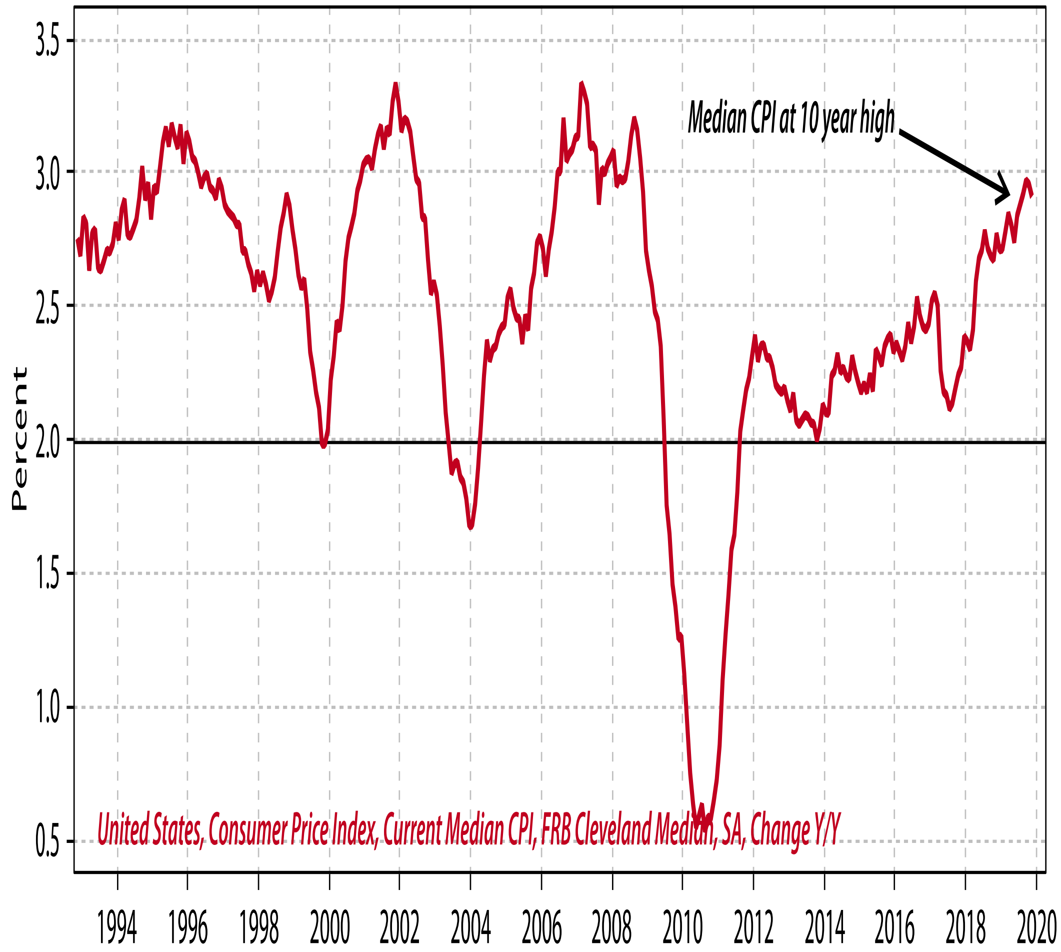
Inflation is at a decade high, in spite of strong US$ and plentiful energy

United States, Consumer Price Index, All Items Less Food & Energy, SA



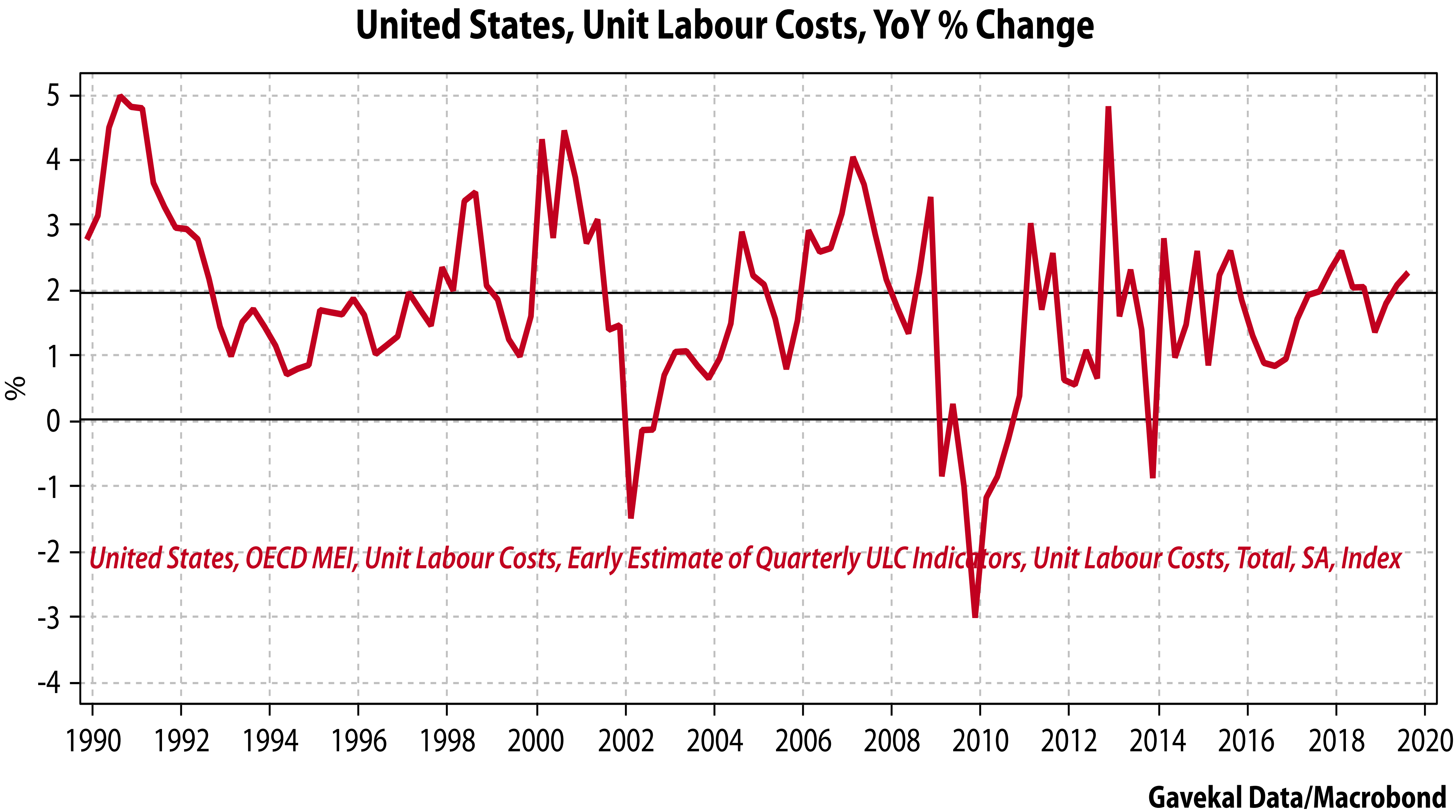
Gavekal Data/Macrobond

United States, Current Median CPI, FRB Cleveland Median, SA, Change Y/Y



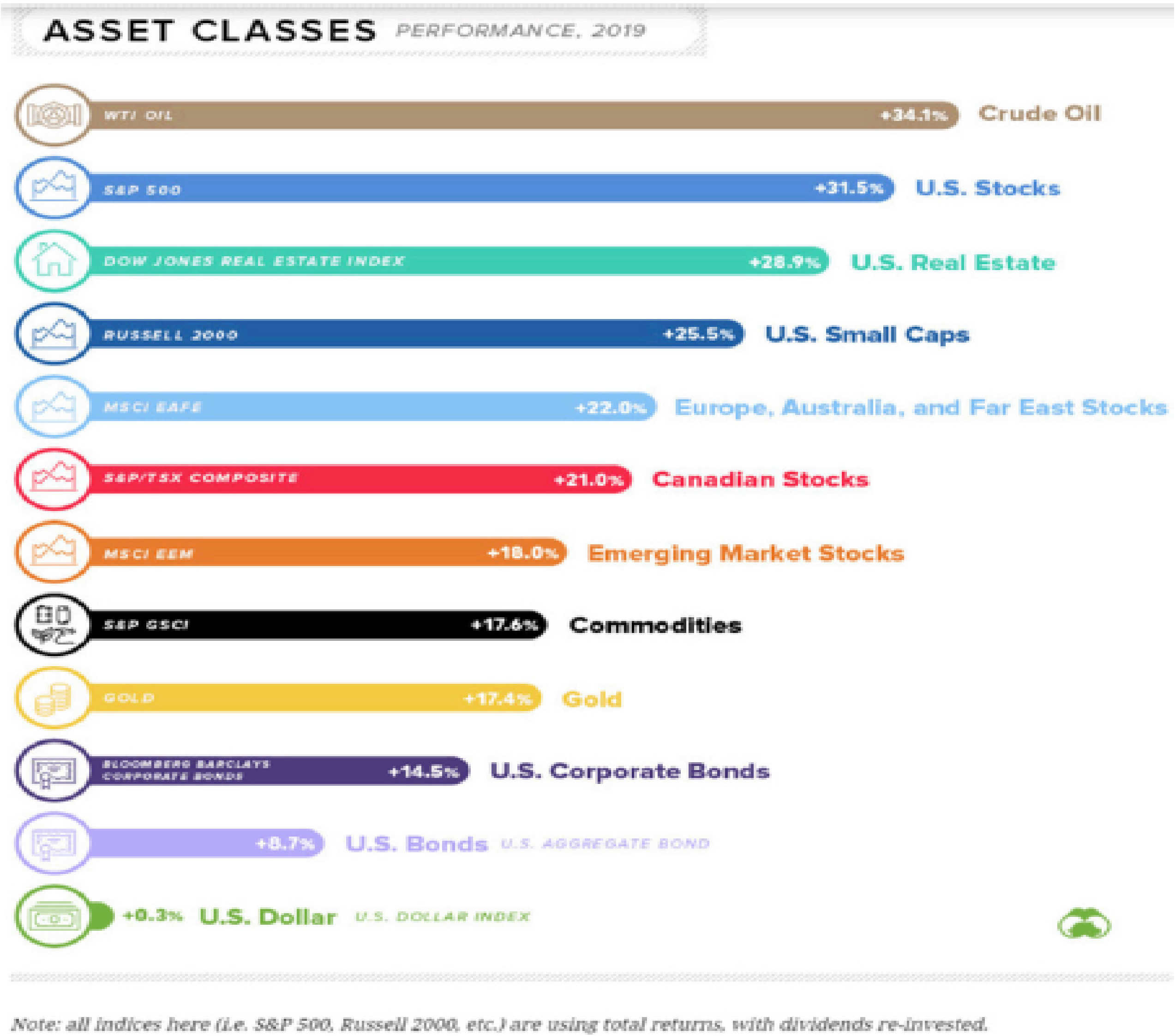
Gavekal Data/Macrobond

Strong US$, weak global growth, weak manufacturing… ULC at 2.51%?



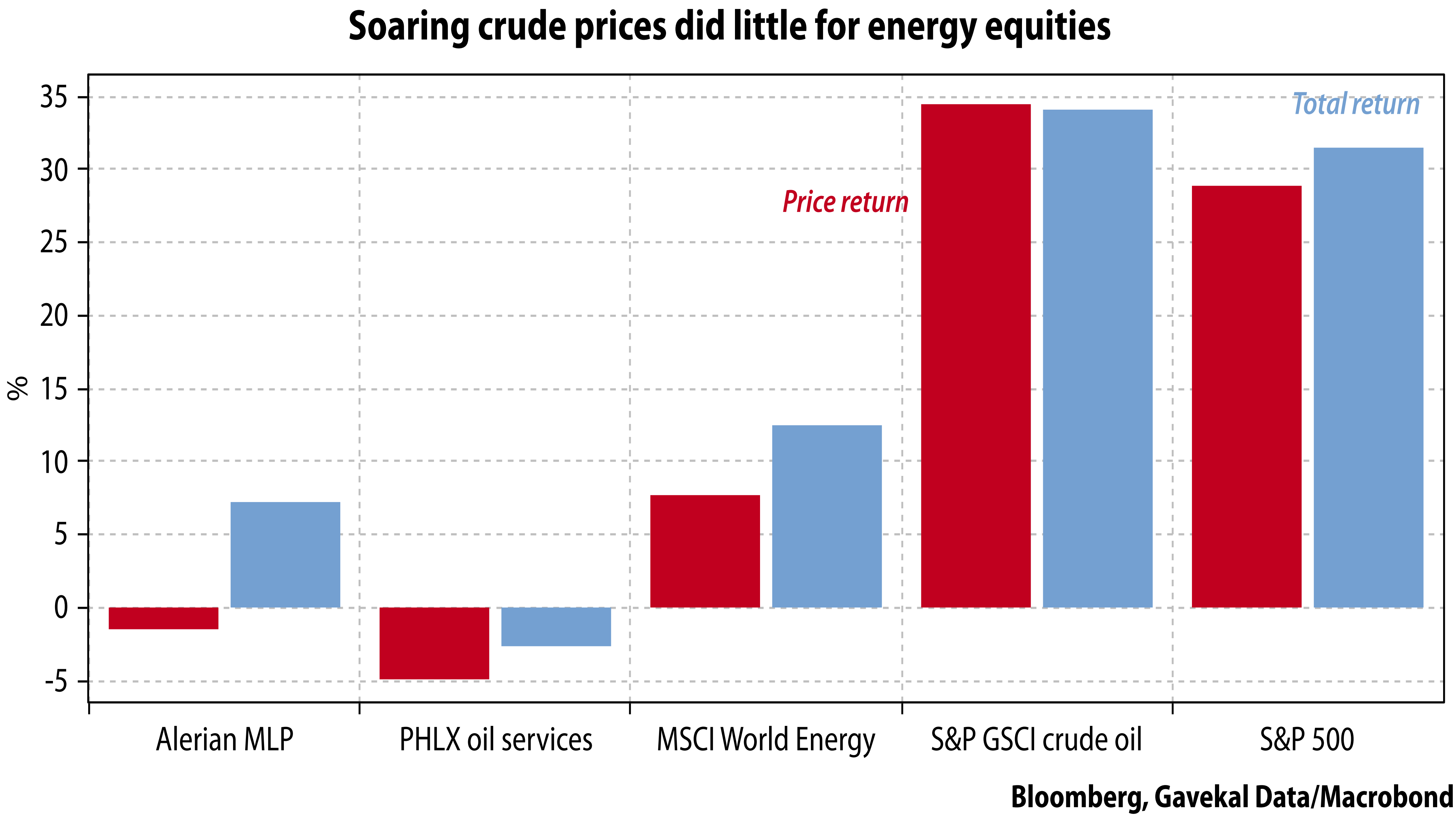
#4 Surprise of 2019: oil and energy investing

Which major asset class outperformed the S&P 500 in 2019?

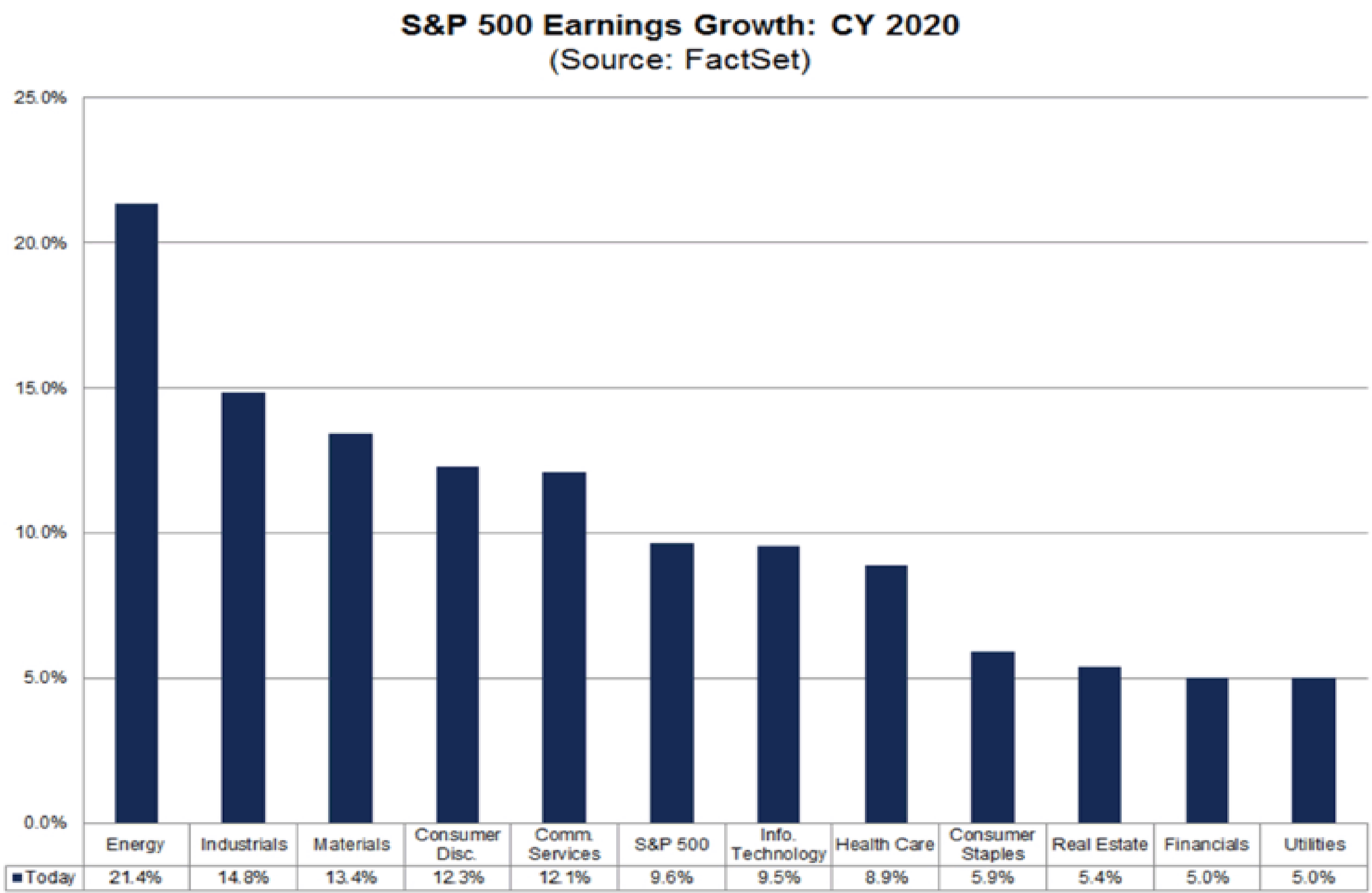


Source: Visual Capitalist

Though you wouldn't know it looking at energy stocks!



Dismal performance in spite of solid EPS growth outlook

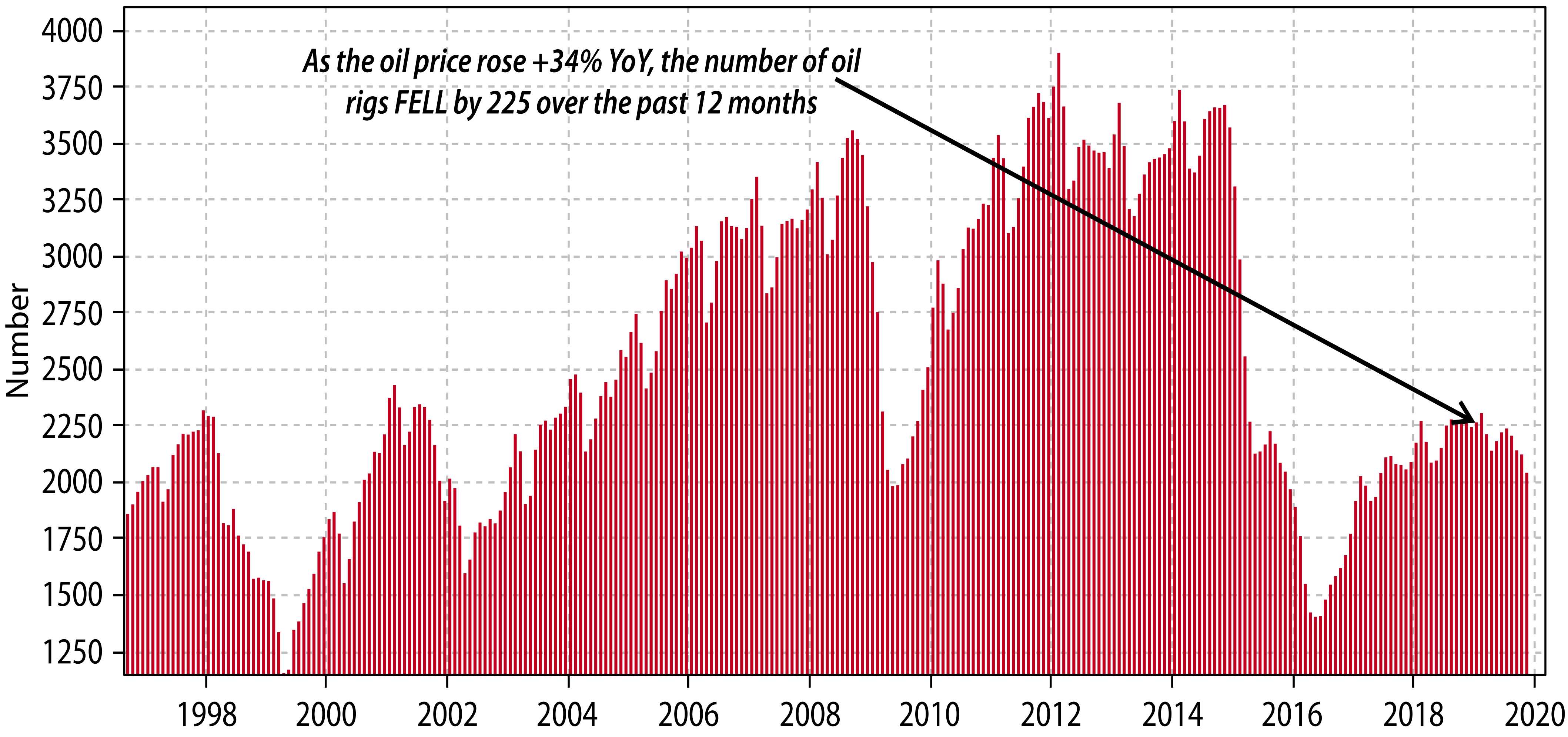


Source: FACTSET

GavekalResearch

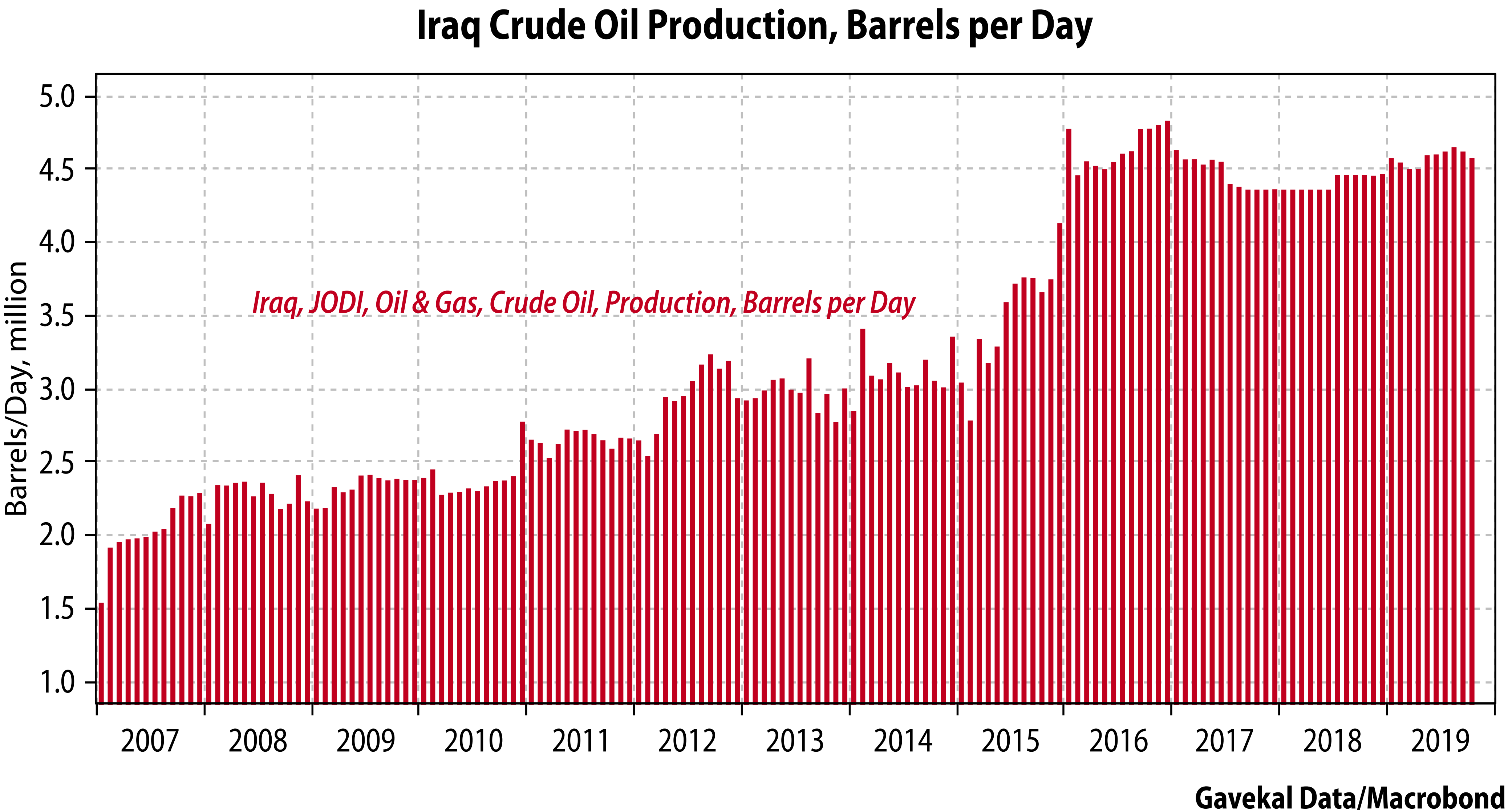
Begging the question: has energy now become un-investible?

Oil rigs in activity around the world



Gavekal Data/Macrobond

The upside risk on oil: renewed Iraq civil war?



As investment into energy crumbles, what will happen?

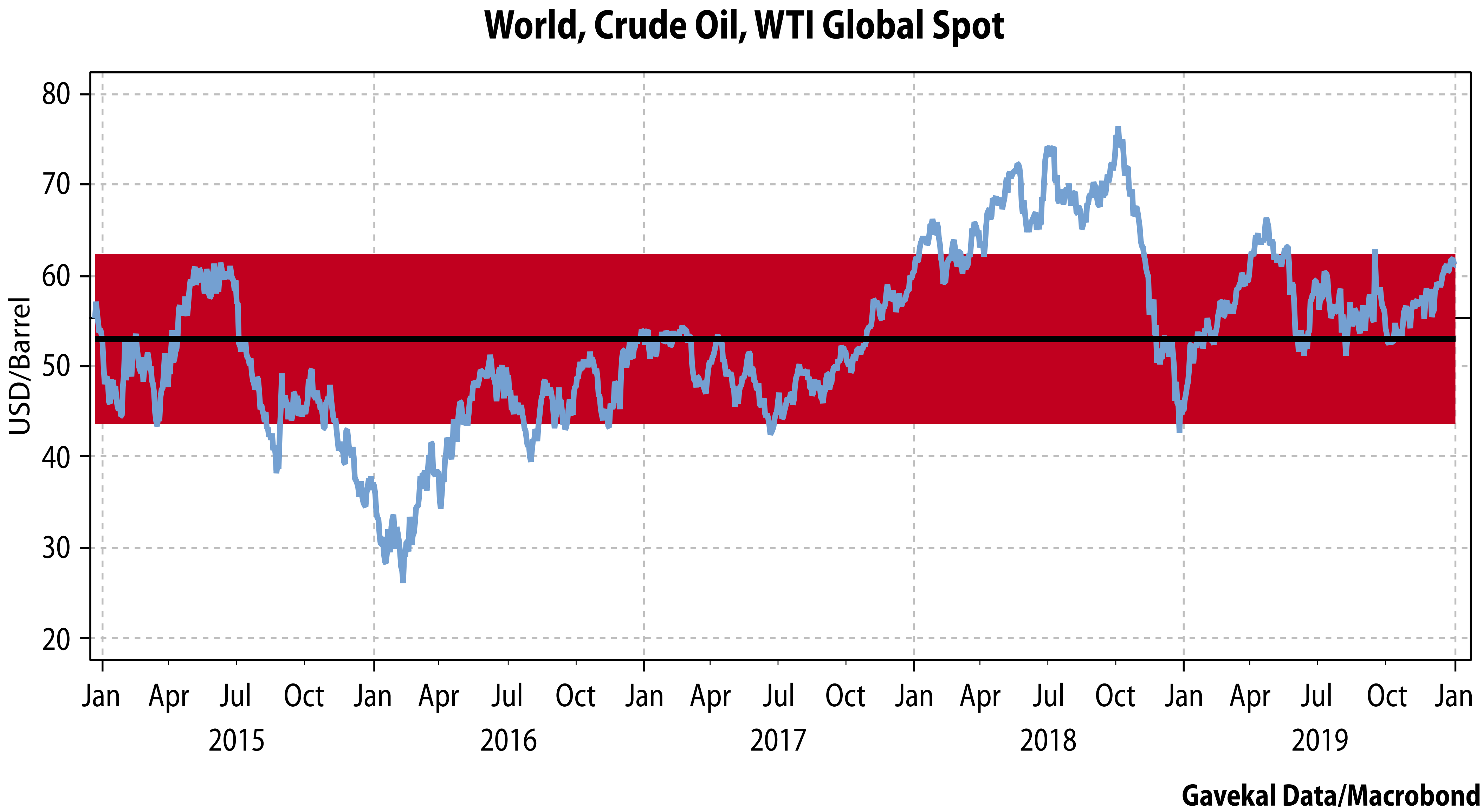
- **Will oil prices collapse?** With investments in production falling everywhere, and given the current reflationary efforts of global central banks and finance ministries all around the globe (ex China) this seems unlikely. In order to see lower energy prices, we would either need a revolution in supply, a significant change in consumption behavior, or an economic crisis…

- **If oil prices do not collapse, then profits within the energy sector will likely turn out to be stronger than almost any other sector?**

- **Will rising EPS growth within the energy industry trigger automatic buying from algos?** Perhaps. Or perhaps not? Perhaps many institutions have excluded energy stocks from their potential investment target lists?

- **If share prices do not rise, we will likely witness a wave of M&A, LBOs, MBOs and private equity take-overs in the energy sector.** This seems like the path of least resistance… Except that debt funding for energy plays is increasingly unavailable.

Will 2020 be the year of the energy price break-out?



Are we entering the 'late cycle'?

We enter the 'late cycle' when scarce resources become constrained

- **The first scarce resource is oil:** Here, somewhat amazingly, we may have chosen to organize a shortage for POLITICAL reasons. For now, oil remains within its recent trading range. But we are bouncing along the upper range…

- **The second scarce resource is labour:** Here, after 20+ years of deregulation, de-unionization, and globalization, a number of countries (not least of which the US) seem intent on re-organizing a SHORTAGE of labour… and this at a time when unit Labour Costs are already rising at decade highs. So just like for oil, we are bouncing along the upper range, and 2020 could well be the year when we break out on the upside.

- **If oil breaks out, and labour costs break out, how will policy-makers respond?** In the past, such a combination would have triggered tighter fiscal and tighter monetary policies. But today, policy-makers seem quite intent on taking a step back and letting inflation run ahead. **In turn, this raises the question of whether we can be in a "late cycle" if central bankers continue to sit on their hands**?

So what does all this mean for portfolios? Currencies

- The US$ is done rising and could well have started a decline which, given the US fiscal situation, could be challenging to arrest. **Sell the US$**
- Meanwhile, China at this juncture is the only major country not stimulating aggressively, and the only major country that likely wants to see its currency move higher in 2020. **Buy the RMB**
- A strong RMB is usually good for the broader Asian and EM space. With that in mind, **most EM currencies should have a solid 2020**
- If, as we believe, 2020 will witness more attempts at capital opening from China, this should be good for the **AUD, CAD, Gold**…
- The GBP remains the cheapest major currency out there. And Britain leaving the EU will allow the UK to go through a deregulation boom. **Buy the GBP**
- In a risk-on world, there are few reasons to own the JPY. The JPY has been the worst performing currency over the past three months and could well keep that crown in 2020…

So what does all this mean for portfolios? Fixed Income

- In a world where China is both a) the only country not stimulating aggressively ad b) likely to increase the availability of domestic assets to foreign investors, there is a genuine risk of a melt-up in Chinese bonds. **Buy China fixed income**
- In a world in which the US$ stays flat or goes down, and a world in which the Fed actively injects tens of billions of liquidity into the system every week, there is every reason to reach out and grab the higher yields offered by **EM local currency debt**.
- Perhaps the single most important development of 2019 that no-one talked about was the announcement by the Swedish Riksbank that NIRP had been a failure, and that consequently, Sweden would move back to pushing its term structure of interest rates back into positive territory. Such a realization represents a real danger for EMU bonds and Japanese bonds. **Sell German Bunds and Japanese government bonds**.
- Perhaps the greatest risk to the unfolding liquidity driven bull market in almost every asset is that corporate spreads in the US start to widen. This could happen because of the lack of counter-parties, liquidity skews, or plain all bankruptcies. Nonetheless, one has to admit that, so far, waiting for wider spreads has been akin to waiting for Godot.
- With inflation the main risk in the system, **TIPS are a better bet than UST**.

So what does all this mean for portfolios? Equities

The rotation from growth to value, and from US to international, failed to materialize in 2019. Will 2020 be any different? The answer to that question will be determined by:

1. **The direction of the US$:** a breakdown of the US$ below 95 on the DXY should trigger the rotation in earnest. The fact that gold has lately started to break out leads us to believe that this may happen sooner rather than later.
2. **The shape of yield curves:** if yield curves continue to steepen (our belief), then financials should outperform everywhere. Given their relative weights, this would help international markets relative to the US. Needless to say, a move away from NIRP would only accentuate this trend.
3. **The direction of energy**: somewhat oddly, just as the US become the world's #1 energy producer, the weight of energy in the S&P 500 fell to all time lows. Meanwhile, if energy (and other commodities) continue to rally, this should be good news for a number of Emerging Markets.

I am bullish financials, bullish Emerging Markets, bullish Europe, bullish energy, bullish deep cyclicals, bullish Japanese equities.

Head Office
Suite 3101, Central Plaza
18, Harbour Road, Wanchai, Hong Kong
Tel: +852 2869 8363 | Fax: +852 2869 8131

Beijing Office
603 Soho Nexus Center
19A Dongsanhuan Beilu, Beijing 100020
Tel: +86 10 8454 9987 | Fax: +86 10 8454 9984

www.gavekal.com

For more information contact sales@gavekal.com